SPECIAL FEATURE

Privatization in Hungary: Results and Open Issues

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The course of privatization in Hungary has been neither direct nor uniform. It has followed a multitude of byways, as state assets were variously distributed for free, sold or auctioned off, sometimes for good money and sometimes at bargain-basement prices, with the process occasionally marred by corruption and scandal. Despite setbacks and detours, today the bulk of state property in Hungary has been privatized and private ownership prevails as the institutional cornerstone of the country's economic transformation.

Because the methods used to achieve privatization in Hungary have had a direct impact on the outcomes, this paper analyzes the benefits and drawbacks of the various approaches the country has utilized. It also outlines what remains to be accomplished before institutionalized privatization is fully implemented.

Hungarian privatization can boast several major achievements. For one, the scale of property still owned by the state has been greatly diminished. For another, ownership of formerly state-owned companies has flowed largely to genuine private proprietors and strategic investors rather than to institutional investors, with ownership and management decisions concentrated in a few hands.

According to official statistics, private firms accounted for nearly 80 per cent of the country's GDP in 1997. The share of property in private hands reached almost three-fourths of the country's assets, of which domestic investors held close to 40% and foreign investors the balance. Statistics take all foreign investment as private, although in several cases—mainly in the energy and telecommunications sectors—the new shareholders are themselves state or municipality-owned.) The share still held by central and local governments fell to 16 and 9% of the assets, respectively, and other non-private institutions 2%.

New start-up operations and greenfield investments were a factor in these results, but Hungary's privatization program accounts for the lion's share. Of the 1,858 enterprises in the portfolios of Hungary's privatization agencies, 1,188 (68%) were fully transferred to private investors by the end of 1998, while roughly 700 units were liquidated.

The evolving terrain

The economic climate for privatization in Hungary, like that in most other Central European countries, was hardly encouraging in the late 1980s. The potential supply of state assets to be sold off was enormous. State ownership exceeded 85% of Hungary's assets in the so called competitive sector. Agriculture was organized into state farms and party-state controlled co-operatives, and most retail trade, most of small business and services

Ownership structure of companies (% in assets)

	1992	1993	1994	1995	1996	1997
Total domestic private owners	25.1	29.0	32.9	35.2	34.7	38.2
Foreign owners	10.1	16.1	18.9	28.4	31.5	35.3
Total private ownership	35.2	45.1	51.8	63.6	66.2	73.5
Total state and other	64.8	54.9	48.2	36.4	33.8	26.5

Source: Pitti, Zoltán (1998)

also were nationalized. The structure of industrial enterprises was highly concentrated. Most Hungarian enterprises faced deep financial and market crises as a result of weak competitiveness on world markets and changes in the domestic regulatory environment.

Demand for privatized Hungarian assets was no better. Domestic savings were insufficient to buy up the state assets to be put on the market, while foreign investors potentially interested in Hungary faced daunting political and economic obstacles. They were discouraged by such deficiencies as a weak legal system, poorly developed capital markets, and an absence of financial intermediaries. These conditions made it unfeasible for Hungary to copy the model of reducing state ownership applied in full-fledged market economies.

The innovations introduced to implement privatization were based on special features of the Hungarian planned economy, and they built on earlier attempts to inject market forces.

By the time the country's comprehensive privatization program started in Spring 1990, Hungary had already moved away from a rigid planned economic system and full-blown state ownership. For example, previous reforms had promoted the emergence of small private businesses, and these were legalized from the early 1980s. Several market institutions, like a two-tier banking system, had been created before the political turnover. Other reforms of this kind included the introduction of several types of securities, a tax reform, policies enabling the formation of joint ventures with foreign partners, and a company law providing a framework to fund shareholding companies. Likewise, in the late 1980s the government sharply decreased subsidies to state enterprises, liberalized foreign trade and relaxed price and wage regulations.

As a consequence of economic reforms under socialism, management autonomy for state firms gradually increased. In 1985 most property rights shifted from central bureaucratic organizations to management via the creation of enterprise councils which introduced self-government. Such councils, established at two-thirds of economic units, consisted solely of insiders. These self-governing bodies obtained the right to determine the enterprise's organizational structure, to appoint the chief executive, to decide on mergers, to split up into smaller organizations and to create joint ventures with foreign firms with the state assets under their control.

"Spontaneous" privatization

The dispersed ownership model that resulted from these earlier reforms served as the starting point for several unconventional solutions.

The first innovation, the so-called "spontaneous privatization" adopted between 1988 and Spring 1990, was based on these self-governing units and the new company law. Several dozen large enterprises, facing vanishing markets, spiraling debt and cutbacks in state subsidies, divided themselves into groups of companies. The aim was to segregate lossmaking units, giving the more viable ones the opportunity to find new owners, to pursue new markets or to offer debt-equity swaps to banks and other creditors.

As a general rule, the central enterprise implementing the restructuring remained the majority shareholder of the new companies formed from the factories and other assets of the larger firm. Although these enterprise centers often called themselves holding companies, they preserved the traditional socialist enterprise form and remained in state hands. Thus, most of these "spontaneous privatizations" were not privatizations in the real sense. The primary goal of top management of these corporatized entities was to ensure the survival of the big enterprise frameworks. What they did accomplish was to create changes in the enterprise's organizational form (called "corporatization" or "commercialization"), which are a precondition of selling shares.

Most of the firms introducing this innovation in the late 1980s failed. Because these enterprises did not attract fresh capital and tap new markets, corporatization provided only temporary relief. Within a few years, almost all large firms adopting this reform degenerated or disappeared from the market.

Other privatization solutions

Since these management-initiated "spontaneous privatizations," successive Hungarian governments have experimented with other unconventional approaches. Unlike in other post-socialist economies, mass privatization methods played a marginal role in Hungary. Nevertheless, free distribution of state assets appeared in several forms. The motivation of government officials was both social and political, namely to serve justice, to create a broad middle-class with it's own property and to win votes in parliamentary elections.

Free distribution concerned institutions such as churches, local governments, social security funds and certain groups of individuals. The most widespread method of the latter approach was restitution. Compensation notes valued at around HF 220 billion were distributed to two million citizens, who had been deprived of their property or whose human rights had been violated during World War II and under socialism. The freely tradable compensation notes could be used in

auctions for agricultural land, converted into shares of state firms listed on the stock exchange, or substituted for cash in purchasing privatized companies. The process of compensation was not complete as of Spring 1999.

The Small Investor Share Program was another attempt of nearly free distribution. The project, similar to the Czech coupon system, offered all Hungarian citizens the opportunity to become owners of the companies involved in the program, practically with no personal investment. The first phase, offering shares in only two companies, started just before the 1994 parliamentary elections. The new government stopped the initiative, however, and thus the program died.

Some privatization methods aimed at sale of assets on preferential terms. In this category, the use of the "existence loan," or E-loan, was the most widespread. Such E-loans, which were long term credits with a five-year grace period and an interest rate well below the rate of inflation, could be used only for buying state assets from the government's privatization agency. The first central privatization organization, the State Property Agency, was set up in 1990 to manage the selling of state property. Two years later another unit, State Holding Company, was established to control a special group of firms which the state intended to retain a stake in the long run. In 1995 the two organizations were merged into the Hungarian Privatization and State Holding Company. E-loans contributed to employee and management buyouts. They played a role in more than 400 transactions valued at HF 68 billion between 1990 and 1998.

Employees of all enterprises could buy shares in their own companies on preferential terms other than E-loans up to 10% of the assets, even if the firm was sold to outside investors. Employees of companies listed on the Budapest Stock Exchange, who obtained the shares at a special option price, achieved especially high returns. Small investors as outsiders often received preferences in the form of installment payments in initial public offerings (IPOs). Other preferential methods, less commonly used, included privatization leasing, which accounted for only 27 cases valued at HF 6 billion.

Unforeseen weaknesses

These methods of free or preferential privatization did help attract private domestic capital, but not on the intended scale and not necessarily the targeted social strata. In some cases, the programs actually slowed the privatization process. It became obvious that the main obstacle was not a lack of demand for attractive state-owned assets but a shortage of promising investment opportunities: neither individuals nor institutions were willing to accept underperforming assets even as gifts.

Moreover, beneficiaries of many of these programs were either unable or unwilling to behave as long-term investors. They quickly sold compensation notes—sometimes for less than the nominal value. Hard-pressed by lack of capital or by debt, the new entrepreneurs—like employees and managers— often sold their stakes to outsiders. Similarly, local governments and other nonprofit institutions have begun putting their shares on the market to cover their current expenditures.

Social security funds are the most obvious example of a group with inadequate expertise in corporate governance. They were no better than the central government in managing their newly acquired assets. Governmental decrees were hardly capable of turning those employed in parastate institutions into entrepreneurs or introducing entrepreneurial attitudes into these organizations. Some of the preferential privatization programs, e.g., E-loans and installment payments for IPOs, on the other hand, proved to be relatively successful in meeting both economic and social targets since the preferences were combined with personal risk and personal investment.

Self-privatization

Besides several forms of free distribution and preferential selling, a third innovation of Hungarian privatization centered on transferring decisionmaking and evolved out of the former enterprise autonomy drive. The aim was to speed the process after the obvious failure of the centralized, bureaucratic approach. Under this program, initiated in 1991, the government identified nearly 500 small and medium-sized companies for a special self-privatization project. Accordingly, the State Property Agency reserved for itself only controlling functions, such as legal control and delegated rights and responsibilities of selling the state assets to private consulting firms. The consultants were offered a well-defined incentive scheme, with their compensation depending on the speed of privatization and price. As a result, most enterprises covered by the program were sold.

The big push

As important as these innovations were, the bulk of state assets in Hungary were sold off by more conventional means involving sales or auctions. The basic tools used in this standard approach were the use of auctions (mainly to local buyers in small-scale privatizations), or direct sales to local and foreign investors via public competition, public tender, private placement of shares, and public share

offerings on the stock exchange.

During the short period (1995-96) known as the "big privatization," most gas and electricity suppliers, along with power plants and banks, were sold to strategic investors. Under this program, Hungary has gone even further to privatize its economy than some of its West European neighbors. The stake of the Hungarian state in strategic sectors like telecommunications, banking and the energy industry, for example, has been reduced to a low level.

Another common approach to transferring state assets, which has attracted mainly institutional and financial owners, has been to float shares on the stock exchange. In the second half of the 1990's large pharmaceutical, chemical and oil industry operations as well as machinery manufacturers were listed on the stock exchange.

Need for restructuring

Many state-owned enterprises to be sold were in need of restructuring, given their weak financial, technological and market position. According to the general principle accepted in the 1990s, the best kind of state asset management is privatization: no state restructuring is needed before selling the shares. Nevertheless, all governments took an active role in reorganizing several companies. The amount spent on restructuring from the state budget or by central privatization organizations exceeded HF 600 billion. That amounted to half of all cash privatization revenues.

Like the sale of assets, the restructuring effort ran along several tracks. Certain firms were bailed out on a case-by-case basis. Several restructuring packages also were introduced. A notable one was the preferential treatment of the "dirty thirteen" big companies, considered as strategic firms. Consolidation of state owned banks used up more than HF 400 billion. The state recovered a portion of these expenditures when it later sold off the firms and banks concerned.

In the end, much of the corporate restructuring was accomplished by the new owners after buying state company shares. In some cases, the new owners purchased these shares far below their nominal value, with the obligation to repay the company's debts or to bring in new capital.

Conclusions

Several conclusions can be drawn from the Hungarian experience with privatization. First, its changeable and mixed nature has made it difficult for participants to evaluate the process and has led to a certain lack of transparency. On the other hand, the flexible and pragmatic approach has offered good opportunities to several groups of investors. It also contributed to the significant expansion of the private economy.

Second, the speed of privatization has been influenced both by the methods adopted and the associated decisionmaking mechnisms. Contrary to its original goal, for example, the free distribution of assets actually slowed down privatization due to the uncertainties surrounding both the beneficiaries and the assets. Also, when decision-making was decentralized away from bureaucratic state institutions to private consulting firms, the process accelerated. The most successful in terms of the number of firms privatized were the self-privatization and small privatization programs (the auction sales of retail trade operations, shops and restaurants).

Third, the standard selling methods seem to have had an advantage over the special distribution approaches. The absence of market restrictions and competition between buyers under the standard approach was key to generating higher state revenues and also to developing sound ownership structures.

The proportion of revenues realized under the various privatization routes underscores their relative importance. Nearly 80% of all state privatization income was cash, and more than 75% of the

latter (i.e., 60% of the total) was paid in foreign currencies. Distribution of assets played a much smaller role. The proportion of compensation notes amounted to only 11% and preferential E-loans barely reached 5%.

The pluses and minuses

A major achievement of Hungary's privatization experience is that most state-owned firms were transferred to genuine private consumers rather than institutional owners. Because Hungary largely employed standard selling methods (rather than mass distribution of state assets to individuals, organizations and pension funds), indirect state and institutional ownership is marginal. Investment funds or mutual funds have no significant presence as shareholders. The share of parastatal institutional investors like local governments or social security funds is modest.

Selling for cash to investors who risk their own capital has proved to be important in the context of corporate governance as well. Mainstream economic literature argues that the effective restructuring of firms in post-socialist economies requires that ownership be concentrated in a few hands.

Recent publications indicate that most Hungarian companies meet this criterion. Analyzing a sample of firms with 100 to 2000 employees in 1995, Tóth (1998) found that 75% of them had three owners or less and 80% one majority shareholder. In another sample of big firms (with turnover exceeding HF 200 billion), Kovách and Csite (1998) found 85% of firms had one majority owner in 1997. Broad-based ownership does characterize several dozen large firms traded on Hungary's stock exchange, but in these cases the capital market effectively exercises control.

The presence of strategic investors with a concentrated ownership—which provide additional capital, management skills and access to new markets—has probably played a decisive role in restructuring Hungary's companies and improving their competitiveness. This conclusion is supported by the example of the country's 100 largest companies, ranked by sales. In many respects, this group might be considered a successful part of the economy. A still incomplete sample of ownership structures of the "Top 100" shows that three-quarters of this group have one dominant owner, while the rest are listed on the stock exchange (Voszka 1999).

Most of the strategic investors in big firms are foreign. Foreign-ownership exceeds one-third of all assets and accounts for 60% of all privatization state proceeds. Total foreign direct investment, including greenfield operations, reached $18 billion by the end of 1998. A significant portion of shareholders in this category are multinational firms. The partnership of Hungarian firms—new establishments and former state enterprises alike—with these multinationals gives them access to corporate marketing and other networks and provides a more global perspective on investment, finance and markets.

On the other hand, some view this concentration of decision-making power as one of the primary risks of Hungary's privatization. Concentration appears not only in the ownership structure of individual firms but also in terms of the economy's overall assets and output. The 200 largest companies accounted for more than a third of the country's production and half of its profits in 1997 (*Figyelõ* 1998).

In many sectors, privatization has had the effect of preserving national or regional monopolies. Although several big firms were broken up into smaller units as a result of spontaneous privatization or direct governmental decisions, in other cases the top management of some firms as well as some state administrations hindered the process since they had an interest in keeping their monopoly positions intact. Sales by monopolies normally generate more budgetary income and mean fewer transactions for overburdened bureaucrats. Market concentration has also been strengthened by a recent

Concentration of ownership structure of "Top 100" (1997)

Number of owners	Number of firms	% of registered firms (N=86)	Number of firms with one majority owner[1]	% of firms with one majority owner (N=86)
One	49	57.0	49	57.0
Two	1	1.2	1	1.2
Three	0	0.0	0	0.0
Maximum 3	50	58.1	50	58.1
More than 3	36	41.9	16	18.6
Total	**86**	**100.0**	**66**	**76.7**

Source: Voszka (1999)

[1] with more than 50% of shares

wave of mergers that has caught up private domestic firms and their owners.

The dominance of a few large companies in some sectors has acknowledged drawbacks. Not only does it mean less competition, but it also makes the Hungarian economy more vulnerable to market cycles and to the changing strategies of foreign investors. A cutback of production or exports by even a few of the biggest firms could create troubles for the economy as a whole.

The other weak point is the social ambiguity surrounding the legitimacy of privatization and private property in general. The fortunes made in privatization or in other ways by private investors during the last decade are looked upon with suspicion. The process has been marred by limited transparency, direct political influence on several privatization decisions and public revelation of some scandals. Thus, public opinion seems unlikely to turn more favorable in the near future.

In order to change popular attitudes, people will have to be convinced by their everyday experiences that individual wealth is closely linked to performance. They will have to see evidence that the initial acquisition of property is not a life-time guarantee of financial success and that competition ultimately eliminates incompetent or unfair owners. Creating conditions that allow new entrepreneurs to enter the market relatively easily would also be helpful.

The end of privatization?

Given that the structure of private ownership in Hungary already closely mimics that of several West European countries, many predict the waning of institutionalized privatization as a central issue of economic policy. Nevertheless, the privatization process will go on for some time. A large number of assets are waiting to be sold off, and issues such as so-called long-term state ownership need to be resolved.

In the latter category is the disposition of roughly 200 firms in which the state intended to reserve a long-term stake for itself (from one golden share to 100%), as defined in the country's 1992 privatization laws. The list of the companies and the proportion of potential private ownership have been revised several times during the last seven years by legal amendment, and they might be again. At the end of 1998, more than 180 firms fell in this category; in 31 cases only one golden share was reserved for the government. From this group branch ministries were the owners of 91 units, and the rest—with an asset value of HF 300 billion—belonged to the governmental agency, the Hungarian Privatization and State Holding Company.

Aside from these reserved enterprises, the state controls another 126 companies with nearly the same value that can be sold even under current legislation. Hungarian Investment Bank, a 100% state-owned institution, is also the asset manager assigned to sell another several dozen firms after they are restructured. In addition, after the recentralization of social security funds in 1998, a package of shares with a nominal value of HF 65 billion is to be transferred to new proprietors. Taking all these programs into account, state property worth HF 300-500 billion could be put on the market in the near future.

Several more steps need to be taken before institutionalized privatization in Hungary draws to a close. That includes the establishment of institutional and legal frameworks for controlling residual state property and for selling the leftovers of the earlier privatization process. Debates on these issues started in 1997, and detailed proposals have been made by several government departments and consulting firms. However, as of Spring 1999, no final decision had been made.

International experience provides no general model for long-term state asset management. National systems are influenced not only by the number, size and other economic characteristics of the firms concerned, but by tradition and cultural factors. As they did in the case of privatization, East European countries will have to find their own approaches to state asset management.

The author recommends revision of the policies governing long-term state ownership, including reduction of the list of state holdings and the blocks of shares to be retained.

The author also suggests dividing the tasks of asset management and privatization between two separate organizations, given the widely divergent attitudes and capabilities required for each activity. Based on the lessons drawn from the last decade of privatization, the author advises accelerating or facilitating the sale of the residual state property via decentralized decision-making and by bringing private interests and private capital into the process.