9. Hungary: Share-ownership — A new option for workers

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Introduction

Financial participation exists in Hungary in a number of different forms. In this context, financial participation is understood as involving partial ownership. In any case, forms of profit-sharing which do not involve partial ownership are unknown in the Hungarian economy. In 1992, Parliament adopted Act No. XLIV on the employees' share-ownership programme (*Munkavállalói Résztulajdonosi Program* — MRP), which promotes Employee Share-Ownership Plans (ESOPs).

Financial participation is a natural concomitant of privatization. However, for the time being, and in contrast with Western countries, financial participation in the Hungarian economy is not yet considered to be an instrument for enhancing productivity.

In principle, employees could become important privatization agents as the majority or even full owners of companies. Many people argue that state assets should be transferred to employees free of charge so that they can run them at their own risk, as responsible market agents. So far, very few of the State's assets have been transferred into majority employee ownership. However, other, less ambitious forms of employee ownership are spreading, such as property notes or shares, which entitle their owners to a regular dividend. Employees obtain some percentage of the company's assets in almost all instances of privatization. There are nevertheless serious limits to the extent of employee share-ownership, despite the fact that the current transformation of the economy provides an excellent opportunity for the emergence of employee ownership, which is so popular in some other countries.

Why is financial participation not playing a more important role in Hungary? An attempt will be made to provide part of the explanation, firstly by describing the transition from a planned economic system to a market economy. The conditions under which the transition is occurring go some way to explaining the various forms of financial participation which currently exist in Hungary. These are then described in further detail. In the almost total absence of statutes on the various forms of financial participation, the analysis is primarily based on data which are at the

disposal of the authors and information extracted from official documents and the press. In addition, several case studies have been carried out covering a number of enterprises, and these are described in section 3.[1]

1. The historical process

1.1 Decentralization of state assets

The political transition which occurred in Hungary during the spring of 1990 put an end to a long series of attempts to reform the planned economy. It was decided to move towards a market economy.

Privatization (the transfer of state assets to real owners who bear all the consequences of their economic decisions) has played a crucial part in this process. Indeed, privatization seems to be the only way to replace what the economist Kornai (1983) called the bureaucratic coordination of the economy. According to data published by *The Economist* (1991), the share of state ownership in Hungary amounted to 86 per cent in the mid-1980s. This was somewhat lower than in other former socialist countries, such as Czechoslovakia (97 per cent), the German Democratic Republic (97 per cent), USSR (96 per cent) and Yugoslavia (87 per cent), but higher than in Poland (82 per cent). At the same period this share was 17 per cent in France, 14 per cent in Italy, 11 per cent in the Federal Republic of Germany and in the United Kingdom, 6 per cent in Denmark and 1 per cent in the United States.

The figures for Hungary presumably include cooperatives. The cooperative sector, notwithstanding its name, was also under state ownership and control. Cooperative members were only nominal owners of the assets of their cooperatives. The activities of cooperatives and state-owned companies were governed by similar rules, such as wage regulations, and the largest proportion of their assets was controlled by the regional or national central authorities, but not by the cooperatives themselves.

This predominant ownership structure was also reflected in the structure of employment. In 1988, out of about 4 million wage-earners, 69 per cent were employed by state-owned companies, 23 per cent by cooperatives and only 8 per cent by the private sector (CSO, 1990). Today, the proportion of employees in the private sector has risen as a result of the transfer of companies to foreign ownership, the continued operation of small cooperatives which had always operated as *de facto* private enterprises and the emergence of newly formed private companies, particularly limited liability companies. At the end of 1991, about 20 per cent of workers were employed in the private sector. State-owned assets, which were

[1] The project relied on the expertise, as researchers and trade union specialists, of György Lajtai and László Neumann. The case-studies were carried out by György Lajtai and János Hovorka.

usually pooled in over-concentrated large organizations (often with several thousand employees) for the purpose of the centrally planned control of the economy, began to be transformed in 1988 (under the Companies Act of 1988). The Transformation Act which was adopted in 1989 made it legally possible for state-owned firms to be transformed into various forms of association; however, the sole owner remained the State. From 1991, this possibility became an obligation. Each state-owned company had to be re-established under one of the newly determined forms of association. An Act adopted in January 1992 introduced similar provisions for cooperatives. The assets of cooperatives had to be returned to their members and future cooperatives will have to adopt the principles of the International Cooperative Alliance. Many cooperatives are expected to become regular business organizations.

This change of form has been accompanied by a massive decentralization of companies. Units of various sizes (facilities, sites) belonging to large organizations have formed "autonomous" companies (such as joint-stock companies and limited liability companies) (see table 9.1). Nevertheless, this change in organization has not necessarily meant a change in ownership. Most new companies are partly owned by a state-owned bank (as the owner of their principal debt) and by their (state-owned) subcontractors, suppliers and customer organizations, through loans or equity swaps. Some new companies are associated with international and domestic private funds, most of which once again come from previous partners of the company.

Table 9.1. Number of joint-stock and limited liability companies, Hungary, 1988-92

	1988	1989	1990	1991	1992
Joint-stock companies	116	307	646	1 072	1 712
Limited liability companies	451	4 485	18 317	41 206	57 262

Source: *Statisztikai Havi Kölemények* (Monthly Statistical Bulletin), CSO, 1993.

Transformation is also a way of preparing for the sale of shares and business units. At the beginning of 1992, only 21 public companies were quoted on the Budapest Stock Exchange. By the middle of 1993, this number had risen to 24.

International investors have also been active in Hungary since the late 1980s. According to CSO data, 1,578 companies with majority foreign ownership had been formed by 1991. The number of companies which were wholly owned by the foreign investor was 1,499. By 1992, 3,030 companies were wholly in foreign ownership (CSO, 1993).

1.2 Employee share-ownership in the privatization of state-owned assets

Since 1990, the task of selling state assets has been assigned to the State Property Agency (SPA). The rules governing privatization are adopted by Parliament yearly.

The Hungarian Democratic Forum (MDF), the leading party of the governing coalition, promised before the 1990 election that it would actively promote employee share-ownership in the privatization of state assets, as indicated in its statement that "State and state-owned companies will, on a large scale, offer their assets, outlets, restaurants, maintenance shops, etc., to their employees, and to any enterprising member of society".[2]

However, in order to cover the servicing of Hungary's heavy debt, the party endeavoured to implement an unusually restrictive fiscal policy.[3] In this context, the prime objective has been to maximize income from privatization with a view to reducing the national debt. Opportunities for employee participation have therefore been seriously diminished by the so-called Property Policy Guidelines adopted by Parliament, as well as by the availability of credit facilities.

It is a stated aim of privatization to sell assets at their market value in order to reduce the national debt to the greatest feasible extent. This made employee share-ownership acceptable only as a component of a system of wage incentives, especially where employee skills, knowledge and commitment are vital factors in the success of the enterprise. However, this longer-term approach was not really endorsed by government policy (Neumann, 1991). The policy pursued by the administration is reflected in the following figures. In 1991, the revenue from privatization of HUF40.1 billion included only HUF5,200 million of sales in Hungarian forints, while the rest was in other currencies. In addition, loans of HUF1,400 million were provided to entrepreneurs to assist in the purchase of state property. These two figures include the value of preferences granted to employees.[4] The proportion of preferential employee shares was further curtailed in 1992 by the Property Policy Guidelines. However, in view of the poor results obtained so far from the privatization process, there are plans to offer more favourable credit facilities to support employee buy-outs of state assets and to enhance the self-employment potential of both individuals and companies.

[2] Statement made in an invitation to the MDF election meeting in September 1990.

[3] The 1991 budget of HUF 851 billion included debt servicing of more than 110 billion. The budget deficit was more than 110 billion, as against the planned target of 78 billion. In the middle of 1993, the deficit again reached some HUF 138 billion.

[4] See "Privatization enhances the propensity to invest", in *Népszabadság*, 25 Jan. 1992.

2. Current and future forms of financial participation

At the end of 1992, the two schemes of employee financial participation in Hungary were property notes and equity shares. Both were offered to employees at a discount rate. In addition, employee buy-outs are also possible. A fourth form of financial participation, an ESOP-type scheme (called the MRP) has been spreading since the beginning of 1993.

2.1 Property notes

The securities known as "property notes" in this chapter are instruments for corporate fund raising. It was made possible for Hungarian enterprises to issue property notes under a Decree which came into force on 1 January 1989,[5] before the beginning of the transformation programme and before any political decision had been made on privatization.

The purpose of these securities was undoubtedly to provide a channel for the financial participation of workers in state and cooperative enterprises. The Decree provides that "The state enterprise, trust, [...] or cooperative [...] may issue property notes in order to increase its own financial means and to create a long-term property-based interest [...]." (section 1, paragraph 1). Property notes could be sold or distributed free of charge to designated employees of state and cooperative enterprises. They entitled their owners to an annual dividend which was dependent on company profits. Property notes could be issued against the enterprises' profits after tax up to the equivalent of a maximum of 10 per cent of a company's assets at the time of issue. The nominal value of the free property notes increased the capital of the enterprise.

It was mainly prosperous organizations which took advantage of the property notes option. The distribution of part of its profits in the form of a dividend on property notes provided the company with a way of avoiding the wage tax and of withholding funds which could be used at its discretion. Above a certain ceiling, however, companies were liable to a progressive wage tax.

The property notes distributed in lieu of wage increases did not offer any substantial benefits to employees, since dividends were both insignificant and uncertain. This is probably the reason why employees did not exhibit any desire to contribute to the assets of their enterprise after becoming owners.

No data are available on the volume of property notes issued. However, until 1990, such bonds were only issued by profitable companies after they had made full use of the available opportunities for untaxed wage increases. The majority of large state-owned companies and cooperatives were in a situation of growing financial uncertainty and were not therefore in a position to take advantage of the facilities. As a result, free property notes were issued by only a few companies. However, there

[5] Decree No. 94/1988 (XII.22), Mt. rendelet.

was a marked change in 1991. New issues of property notes were used as a way of promoting employee ownership. State-owned firms facing transformation and sale sought to distribute part of their assets to their employees. No permission was required from the State Property Agency (SPA) to issue property notes, which could be distributed free of charge. Once the firm had become a company, the property notes could be converted into employee shares in the new organization (however, the permission of the SPA was required for this latter operation). Property notes were therefore issued in large numbers in 1991. Before the SPA had any chance to interfere, firms had begun to distribute part of their assets to employees. One example is the Automotive Repair Service Company (ARS), which was engaged in extensive operations including tool production and car wrecking. The ARS distributed a substantial number of property notes to its 200 workers. On the bases of its 1989 profits of HUF50.5 million, the firm issued property notes to a value of HUF11 million for allocation to its employees. Another issue of property notes to a value of HUF2 million was sold at a discount. In 1990, an additional HUF2 million issue was made on the basis of its profits of 43.6 million. On 1 January 1992, the firm was transformed into a joint-stock company named Ferradial. Although 79 per cent of its equity remained the property of the State, the share of employees in the form of property notes amounted to 8 per cent.[6] Property notes were distributed in every sector of the Hungarian economy in a similar manner by virtually all state-owned companies undergoing transformation which showed a profit. However, there are no data available on the value of property notes and the number of employees holding them.

The financial losses of an increasing number of firms set a limit to the distribution of property notes. Many firms have been placed in a critical position by the abrupt collapse of Eastern European markets after the second quarter of 1990. Moreover, after a long period of artificially controlled insolvency, a serious wave of bankruptcies was triggered between 1992 and 1994.

2.2 Employee shares

Employee share-ownership is the form of financial participation which is being developed during the privatization process. Provision for employee ownership in the privatization of state assets was a significant platform for almost all political parties during the campaign preceding the first free elections. It was also supported by a number of other organizations, including workers' councils and other social groups.

The practical options for employee share-ownership were outlined in the Property Policy Guidelines, first issued in 1990. The document specified that no more than 15 per cent of company assets could be transferred at concessionary prices to employees. Prices and instalment payment plans would require permission from

[6] *Figyelô*, 16 Jan. 1992.

the State Property Agency. A policy statement also envisaged the conversion of property notes, which had been issued earlier, into employee shares.

This new system of employee shares has been adopted mainly in firms, and especially large enterprises, in which the employees could not afford to buy the whole of the assets, even after decentralization. The new system has also been supported by the trade unions, which share employees' fears that (foreign) investors could simply buy their companies over their heads.

Permission from the State Property Agency is obtained by means of individual negotiations between the Agency and the enterprise. A report by the State Property Agency to the Government indicates that, by mid-1991, permission had been given in the case of 20 joint-stock companies. In four of these cases, permission was given for the conversion of property notes into shares. One example is an electrical installation company, in which 5.9 per cent of the capital was already owned by the employees through property notes. The company decided to issue free employee shares in addition to the conversion of property notes into shares. At the Szolnok sugar company, property notes were also converted into shares, representing 3.1 per cent of total company assets. In the Amfora trading company (described in greater detail below), about a quarter of the new shares were obtained through property notes. A fourth company, Richter Gedeon Pharmaceuticals, will convert property notes into preferential shares. The other 16 companies issued new shares during their transformation to joint-stock companies. Of the 20 companies, only one, IBUSZ, is quoted on the Budapest Stock Exchange. It gave its employees access to stock at a discount. In each of these cases, permission for concessionary pricing was requested for shares equivalent to between 1.1 per cent and 16.3 per cent of the company's total capital. The discounts vary from 10 to 100 per cent. The scheme most frequently adopted is "two for the price of one", under which shares are purchased at a 50 per cent discount. Employees have also been offered instalment plans to facilitate payment (such as a 10 per cent down payment, with the balance to be paid over three years).

Although no data are available, the Newsletter of the Privatization Research Institute (set up by the SPA in 1991) collects and publishes the plans of prospective public companies which issue employee shares. The following are examples:

— A second-hand distributor and pawnshop, transformed into a share company, planned to issue employee shares to a face value of HUF200 million from its equity of HUF2.6 billion. Shares to a value of HUF60 million were offered at a 50 per cent discount. In offering its shares, the new company gave priority to its employees over the principal owner, while the SPA tried to sell the whole company to an international investor.

— With the consent of the SPA, EGIS Pharmaceutical Works was transformed into a share company in 1992; its equity of HUF5.4 billion was shared between the SPA (90 per cent) and its employees (10 per cent).[7]

[7] *Privatization Monitor*, 8-14 Nov. and 15-21 Nov.

There have been a few cases of majority employee shareholding. One of these was a commercial building design office, in which the 200 employees bought 54 per cent of the shares. Each employee bought shares for HUF100,000 to 300,000.[8] Remarkably, financial motivation is not one of the reasons why shares are either issued or bought. Experience shows that employees do not believe that shares are valuable.

Nevertheless, employees are of course ready to accept shares if they are allocated free of charge. Even cheap shares are popular. For instance, at the shoe company Tisza Cipôgyár, in which employees could purchase shares at 10 per cent of their nominal value with a 3 per cent down payment, almost all (3,481) of the 3,500 potential buyers bought shares. Each employee could buy shares of a face value of between HUF30,000 and 60,000 for between HUF900 and 1,800. At that time, average monthly salaries in that sector were HUF12,549. In some other cases, however, employees have refused to purchase shares despite preferential conditions. This was the case at the pharmaceutical company Chinoin Gyógyszergyár, which offered 30,000 shares to its employees (with a maximum of five shares per employee) and to its own retirees (a maximum of three shares per retiree) at 10 per cent of their face value. The offer also included an instalment plan under which, of the total price of HUF10,000, the down payment was 2,500, the rest being paid in three equal amounts of 2,500 over a three-year period. This meant that the total down payment needed for a maximum of five shares was HUF12,500, which was less than the average monthly wage in the sector (HUF16,668). Moreover, the shares entitled their owners to immediate dividends. All these discounts and highly preferential conditions notwithstanding, about half of the employee shares offered to the employees were not sold. The employees clearly did not understand the role of the dividend, the growth of which they were unable to predict. Moreover, the company had lost its main market due to the collapse of the Soviet economy and lay-offs were expected by the employees, who also knew that share-owners had no more job security than non-share-owners. All of these factors combined meant that the employees, in practice, showed almost no interest in the shares.

The rule of seniority has been followed by almost all the companies which have introduced employee share-ownership plans. One example is the printing company Kner which, in the course of its transformation, offered its employees 9,500 shares with a face value of HUF10,000 each (which represented 10 per cent of its total capital) at a 50 per cent discount. The cash-down payment was 30 per cent of the purchase price. The employees were entitled to buy the shares according to seniority: those with over 35 years of employment in the company were entitled to 19 shares, while those with at least five years could buy a maximum of three shares. At Kner, about half the employees were entitled to buy either three or five shares. Only 1.2 per cent of the employees were in a position to buy 19 shares.

However, a different share distribution system was introduced for managerial staff. Instead of following the seniority rule, they were entitled to purchase shares in proportion to their basic salary. The general manager was entitled to buy up to 51

[8] *Üzlet*, 7 Nov. 1991.

shares for six times his basic monthly salary and the business manager up to 39 shares. Managers of plants or establishments, chief foremen and heads of department could spend up to three times their basic salary to buy between six and 12 shares, while foremen and section heads could only purchase between six and eight shares for twice their basic salary.[9] Nevertheless, even when employees have shown little interest in buying shares, these management privileges have been a source of conflict in nearly all cases.

The maximum level of employee ownership before privatization was clearly limited by the 1992 privatization guidelines. As noted below, plans for employee share-ownership have been attacked, not so much along political lines, but primarily by those who are worried about the impact of workers' preferential share allocations on the state budget. They argue that potential "real buyers" will be discouraged by employee shareholdings.

Although there are no data available on the employee share allocations offered by private enterprises, several examples of companies, and in particular newly established foreign companies, emphasize the potential of employee shareholdings. In existing joint ventures operating as joint-stock companies, the property notes acquired by employees before the international partner came on the scene can be converted into company shares. Moreover, several leading international companies have demonstrated their willingness to offer new shares to employees, probably with a view to enhancing their commitment and productivity. It should be noted, however, that the real incentives normally offered by international investors are immediate wage increases above the national average. These wages are paid locally by the international company and are still normally lower than those prevailing in its home country. The following cases are cited from the *Privatization Monitor*:

Compack Douwe Egbert (food)

The company was formed in 1991. Its Dutch partner owns 51 per cent of its capital. The company offered part of its profits to employees in the form of bonus shares. They were given the option of subscribing to another part of the profits for a modest cash payment. Through these two channels, employee shareholdings can reach a maximum of 5 per cent of the equity of the company.

Julius Meinl Csmege (food retailing)

The Meinl group owns 51 per cent of company capital and the employees own 10 per cent. From the shares still in its possession, the SPA planned to sell new shares to the employees at a 40 per cent discount.

Styl Ruhagyár (clothing)

The company is 84 per cent internationally owned and was introduced on to the Budapest Stock Exchange in 1990. In 1991, the employees of the company were given a portfolio of shares worth HUF55 million. Nearly 1,900 of them opted to become shareholders. The employee shares were transferable and quoted on the

[9] *Figyelô*, 4 July 1991.

Stock Exchange. This practically completed the privatization of Styl, with employees' shareholdings representing 10 per cent and domestic private and institutional investors holding 6 per cent of company capital.[10] However, despite the fact that the value of the stock had doubled a few months later, the majority of employees sold their shares at the first opportunity. More than 50 per cent of these shares were bought back by the firm itself. "We have tried to develop a kind of proprietary attitude, but in vain, because the majority of the people concerned had financial problems in their everyday lives", commented an expert who was involved in the transformation programme.[11]

2.3 Participation in business units

Employees of joint-stock companies have the opportunity to buy shares at a discount. For the employees of limited liability companies, the opportunity may arise of buying business units.

When large state-owned firms found themselves obliged to undergo the transformation into various forms of private company, their units and areas of business became share companies or limited liability companies. In some cases, large individual firms have split into a large number of new companies. A typical scenario is for the state enterprise to contribute production machinery, raw materials, etc., to the new limited liability company. Various foreign and domestic partners, often including managers and employees, have an opportunity to become members of the new company through the contribution of all kinds of capital assets, such as cash, equipment or know-how.

Unfortunately, there are no data on the level of employee ownership in these companies. The following information has been compiled from newspapers and a careful analysis of four limited liability companies, in which majority ownership has been obtained by employees.

Perhaps the best-known case is Videoton, one of the largest Hungarian electronic telecommunications firms, which has nearly 20,000 employees. In 1989-90, Videoton was broken up into 21 companies: three joint-stock companies, 17 limited liability companies and a joint venture. The Videoton company headquarters owned between 51 and 100 per cent of almost all the companies, except for one case in which it owned only 17 per cent of the capital. In this last company, the Precision Tool Production Ltd. *(Preciziós Szerszámgyártó Kft.)*, HUF 6 million of its HUF7 million principal capital were put together by 230 of the 260 employees. The capital needed for participation was assembled by the employees from their personal savings and from loans from their families and friends. The highest property share in any individual's hands was HUF150,000.[12] Spare production capacity at the factory had already been utilized for several years to take foreign

[10] *Privatization Monitor*, 15-21 Nov. 1991.
[11] *Népszabadság*, 18 June 1992.
[12] *Figyelô*, 11 July 1991.

orders. Employees had performed that extra work under an arrangement which was much more liberal than the state socialist enterprise, namely an Enterprise Business Work Partnership. After the transformation of the company, the circle of foreign customers enlarged and the employees started working in the limited liability company as full owners, with good results. When deadlines had to be met, they were willing to spend their evenings or weekends working in the factory. As a result of this kind of employee involvement, the enterprise was successful. By 1991, the employees had already paid back their loans and were in a position to purchase the buildings, machinery and land still owned by the state enterprise.

Three other limited liability companies were also examined. In the first company, employee ownership stood at 50 per cent, and in the other two it was 60 per cent when the limited liability company was established.

The first company, an international freight transport company with 37 employees, was formed from the transportation department of a large state enterprise in 1990. With the abolition in 1989 of the monopoly of state enterprises in foreign trade, the company had lost quite a few customers. The choice was between cutting the workforce by half or accepting a proposal from its managers and employees to establish an independent organization. The second solution was adopted: the company provided one-half of the start-up capital and the other half was contributed by 13 of the 37 employees and managers from their savings and family loans. The parent company was ready to help the start-up by providing orders and the floating capital needed for the first month's operation. The premises, phones and fax machines were rented from the parent company. In return, the new company worked for the parent company at reduced prices. The employees participating in this plan were particularly motivated to preserve their jobs and improve the performance of the company. On the basis of their long professional experience, they were convinced of the viability of the company. Their expectations and hard work were crowned with success: they were able to broaden their market share in spite of tough competition and the general recession. By 1990, they had obtained 140 orders outside the parent company. During the first half of 1991, that figure went up to 600. The basic salary of the members and employees of the company increased by 50 per cent. The managers also tried to increase their share in the company through further investment. By July 1991 (that is, one year after its establishment), 90 per cent of the company was owned by its employees. The managers' stake had increased from 5 to 20 per cent.

The other two limited liability companies were formed on 1 January 1991 from two departments of a large state enterprise in the construction sector. One had 11 and the other had seven employees. Both were formed with the minimum base capital (HUF1 million). The source of the employee shares was the severance pay of the employees laid off by the parent company. Six of the original 11 employees in the first department and three of the seven in the second decided to purchase stakes of between HUF50,000 and 150,000. It is interesting to note that of these nine buyers, four had occupied managerial positions before the purchase.

The main purpose of forming the two limited liability companies was to preserve jobs at a time when the parent company had been placed on the list of state

enterprises to be privatized by the State Property Agency. These two examples are typical cases of management buy-outs, even though their management and funding differed from current Western practice. The growing popularity of management buy-outs is a new phenomenon in the Hungarian privatization process.

Once again, there are no data on the extent to which employees have business shares. Experts generally estimate their extent to be modest. It is important to note, however, that the purchase of stakes in the existing business may turn out to be the most promising path to employee ownership. It has the advantage of preserving existing production capacity, jobs, market knowledge and business contacts through private ownership. It constitutes a realistic approach adopted by employees in small organizations with low capital needs. More and more cases are cited in the *Privatization Monitor* and this form of buy-out has become one of the most popular since the second half of 1992. Bankruptcies, the closure of some of the largest firms and the rise in unemployment have evidently provided a strong incentive to buy up small units.

The system of the so-called "subsistence credit" was, in principle, designed to assist this kind of transformation. The "subsistence credit" consists of a special credit system for the purchase of partial ownership in state enterprises and has been available since March 1991. However, potential borrowers have been discouraged by the very exacting loan conditions (which were somewhat relaxed in January 1992). More recently, this credit facility has become the main source of financing for the formation of ESOPs.

2.4 ESOPs

The concept of Employee Share-Ownership Plans (ESOPs) has been known in Hungary for a number of years and Hungarian experts have long been in favour of its adoption. After a long period of gestation, Act No. XLIV (MPR) was adopted by Parliament on 9 June 1992. Essentially, the programme follows many of the main principles developed in the United States: MRP transformation requires the agreement of more than 40 per cent of employees. A feasibility study also has to be made and the MRP transition must be managed by an organization set up for the purpose. Some items of the Act, especially the provisions respecting loans, were debated up to the last moment. In its final form, the Act requires MRP shares or business shares to be partially funded through the employees' own resources: this proportion is 2 per cent in cases where the per capita purchase price is less than HUF5 million. Above this level, the required proportion of employee resources grows gradually. The Act also provides for a two-year grace period and a ten-year period of amortization and repayment.

Now that the Act has received parliamentary consent, employees in several companies are ready to implement an MRP. These new experiences are reported in the media daily. A recent example occurred when the staff of a bakery decided to set up an MRP in order to buy out at least 25 per cent (out of a maximum of 67 per cent) of the company. This ESOP will be paid up in six to ten years. Through this system,

the workers hope to receive wages as employees as well as substantial dividends as owners.[13]

Several factors give employees the motivation to participate in an ESOP. In a leading china manufacturer, although several international bids were received, the employees decided to buy out the company because they were confident of its economic prospects. High production standards had been maintained through the skills and knowledge of generations of workers. In other companies, the main motivation is to preserve jobs. The company Debrecen Mezôgép Vállalat, a farm equipment producer, had to cut some of its labour force after it lost a large part of its export market in Eastern Europe, which represented 75 per cent of its production. After this experience, the remaining employees decided to buy shares so that, as owners of the company, they would have a say in strategic decisions, particularly those affecting employment.[14]

Although the Act on MRPs was approved by Parliament in 1992, the long-term lending commitment required by the programme shows the conflict in the Government's aims. On the one hand, it is necessary to reduce the budget deficit as far as possible; on the other, it is important to speed up the privatization process, regardless of real income obtained for the national budget. By the second half of 1993, the latter aim had begun to prevail.

3. The attitudes of the social partners and the Government

International experience shows that financial participation is often successful for the following reasons:[15]

— *Employees* are ready to contribute part of their savings (often supplemented by loans) to the material improvement of their firm. This sometimes involves the complete purchase of the company. They are motivated to do so because: they expect a return on their investment (through profit-sharing), especially when they have the feeling that they can improve the value of this investment through their own efforts; they hope to protect their jobs, at least in the short run; and they want to avoid their company falling into the hands of an unknown new owner.

— *Owners* promote employee financial participation in their own interests because they believe that dividends will motivate employees to work more efficiently, cut costs and handle equipment more carefully. This is the reason why large enterprises are particularly willing to hand out shares free of charge or to introduce schemes for the preferential purchase of a certain percentage of shares.

[13] *Pest Megyei Hírlap*, 11 Nov. 1991.
[14] *Világgazdaság*, 1-2 Nov. 1991.
[15] Bregn and Jeppensen (1991), Casey (1991), Jones (1987a, 1987b), Langeland (1991), Toscano and Tucker (1989), Uvalic (1991) and Weitzman (1984).

Profit-sharing, sometimes combined with downward pressure on wages, also allows them to share the risk between owners and employees. The owners of smaller companies, which can more easily be purchased with employees' capital, mostly through preferential loans, are more inclined to sell their property to employees than to an outsider.

— In some countries, the *government* obliges owners to resort to one form of financial participation or another. For instance, the high level of financial participation in France is explained by the fact that profit-sharing is obligatory in companies with more than 50 employees (see Chapter 2).

3.1 Employees

In view of the persistent recession and the high annual rate of inflation (24-28 per cent), employees do not readily understand the potential advantages of financial participation. They have little confidence in shares which promise an uncertain dividend, especially in large enterprises. The majority of the workforce is still employed by the largest (invariably state-owned) firms. Since 1992, many large companies (and their decentralized units, working under different names) have initiated bankruptcy proceedings. In 1992, the Government established a state-owned holding of the 150-160 largest firms with a view to protecting both the firms and the whole economy from the unavoidable effects of their bankruptcy. Shares (which, in addition, had previously been unknown in the Hungarian economy) now offer no promise for the future. Neither wage increases nor supplementary dividends would have any motivational effect in an unstable economic environment.

For employees in large enterprises, it is not really worth while investing in shares. If somebody has some money to invest, bank deposits offer more secure and higher incomes than shares in enterprises. In view of the worsening economic situation, workers prefer monthly cash payments to uncertain yearly dividends.

The company case-studies described in this chapter illustrate the attitudes to shareholding by workers adopted by employees in various situations. A 10 or 15 per cent stake in a company does not give any substantial say in the fate of that company. As a result, those with ownership ambitions and abilities tend to opt for genuine ownership by purchasing entire small plants or by establishing individual enterprises or partnerships.

The presumed role played by employee shareholdings in protecting jobs is currently their most important perceived benefit. This has taken on greater importance with the continued rise in unemployment. Shares, or property notes converted into shares, have become a symbol of hope that their owners will be better protected.

Buy-outs of business units in limited liability companies are also motivated by the desire to preserve jobs, as well as the hope that, after the present uncertainty, the company will grow and be successful. Optimism of this nature has been observed in

the organizations that are planning to implement an MRP programme. An additional consideration is that an MRP is considered to be a means of escaping bankruptcy.

3.2 Managers

The objectives and expectations of the various categories of employees do not vary significantly. However, managers are different. The manager is the first to be exposed to the new owner. Managers are also the most serious candidates for the purchase of business units in limited liability companies. Moreover, they have the necessary experience to keep the business going. Managers are the group most likely to have savings, a solid family background, and friends and acquaintances who are able to lend them money. Moreover, due to their position in the organization, they can play a crucial role in initiating the privatization process and perhaps in finding a new (co-)owner who is willing to consider their interests. For this reason, managers endeavour to accumulate as many property notes and shares as possible. The founding members of limited liability companies formed as spin-offs of state-owned companies invariably include the management (often under preferential conditions) wherever it is possible for employees to acquire a stake.

3.3 Trade unions

Although they are supposed to promote the interests of employees, for a long time the trade unions were unable to agree what their interests were in the privatization process. There are several dozen active trade unions, but they do not have a solid social base. The new system of employee shares was largely supported by trade unions out of a fear that foreign investors could simply buy companies over the heads of the employees. Trade unions are also showing increasing interest in the employment potential of workers' shareholdings.

The most extreme point of view on privatization was expressed by the National Alliance of Workers' Councils. This organization, named after a union involved in the 1956 revolution, but which represents only a fraction of the labour force, demanded the distribution of all state assets. However, this demand did not receive any appreciable popular support.

The trade union association with the largest membership, the MSZOSZ,[16] in the first years of the reforms did not address the problems arising out of transformation and the privatization process. This new association focused its attention on wage problems. It justified its policy by pointing out that purchasing power was falling under the effect of the recession, inflation and increased levels of taxation, resulting in an inevitable decline in living standards.

[16] The MSZOSZ, successor of the former SZOT, which was dissolved in 1990, claimed to have over 2.6 million members in 1991.

The member trade unions of MSZOSZ, as the traditional representatives of industrial labour, supported these claims. They formed no opinion about employee participation when privatization commenced. Moreover, they had good reason to fear that their bargaining strength would be eroded by the decentralization of large organizations and the autonomy of small ones. As the privatization process slowly progressed and it became obvious that the large state-owned firms had to be restructured sooner or later, the trade unions started to give their support to employee share-ownership as a good alternative for the labour force.

The Democratic League of Independent Trade Unions, a union organized from former dissident trade unions which claimed to have 350,000 members in 1992, tried to protect employee interests during the whole of the privatization process. It wanted new owners to acknowledge the existing rights, benefits and social allowances of workers, and participated in determining the extent to which staff would be reduced and the obligations of enterprises towards the workers who were laid off. Although the need for these activities increased as privatization progressed, the member unions of the League did not wield significant power because of their relatively small membership. All unions are undergoing a process of "learning by doing".

A National Reconciliation Council was set up in 1991. Although it endeavours to adopt a tripartite approach, its scope is still limited.

3.4 Owners

For various reasons, the opportunities for the financial participation of owners are equally slim among the four groups of owners, namely individual private owners, corporate private owners, members of cooperatives and the State.

The majority of individual private owners are self-employed or manage family operations. Individual private owners of larger enterprises are extremely rare. Share-ownership is not yet a real option for this category of owners.

Among corporate private enterprises and cooperatives, which continue to represent a fairly large percentage of enterprises, the concept of financial participation has an entirely different meaning since these companies have up to now mainly adopted genuine worker share-ownership arrangements of the cooperative type.

In the case of state ownership, the extent and forms of financial participation are determined by the SPA. The decisions of this body are not determined by the goal of improving economic performance through employee ownership, but rather by an obligation, at least formally, to fulfil political promises made before the election. Owing to the incidence of share transfers at preferential rates, the SPA has been forced to reduce the burden on the state budget by restricting the maximum percentage of employee shares to a rather low level. Managers of state-owned companies also appear to have conflicting interests, such as paying the highest possible wages, which are in contradiction with the objective of reducing costs.

In joint ventures, several types of financial participation can be introduced, thereby enabling employees to make a considerable effort to increase efficiency.

3.5 Government

The Government is forced to manoeuvre between various interests and obligations by searching for compromises. On the one hand, it would like to fulfil the political promise made by all parties in the governing coalition to let employees become property owners. On the other hand, it would like to secure budget revenues from the sale of state assets. Losses of revenue resulting from the decline in profits, and therefore of taxes, from ESOP companies, combined with the long-term loans given to employees to help them buy shares, are a further burden on the state budget.

The instability of the Hungarian economy, which is heavily burdened by inflation, the recession and the uncertainties arising out of transition, mean that the conditions are only favourable for free issue property notes or cheap shares. This form of financial participation does not produce much revenue to cover the state budget deficit. Several decision-makers are also sceptical about the potential of this form of financial participation to motivate workers and improve productivity. Financial participation is clearly less promising in this respect than the transfer of state assets to responsible and fully empowered owners.

Because of the slow progress of privatization and the lack of investors, new plans are being made in 1995 to speed up privatization. These include issuing free coupons for all Hungarian citizens and the sale of state property at nominal prices. The most advanced plan at the moment is the "share purchase programme for small investors". Under this plan, "attractive companies" will be designated as investment targets in the hope that they attract the savings of the population. Everybody will be able to invest in the designated companies on favourable terms, regardless of their occupation.

4. Financial participation at Amfora

This section consists of a presentation of a case-study[17] of the Amfora glass and porcelain company.

4.1 General situation

The Amfora glass and porcelain trading company was established in 1949 as a state firm. From its ten warehouses, located in different cities, it supplied several domestic and foreign firms. In the 1970s, when its sales began to stagnate, the firm started to build up a retail network. At the end of the 1980s, however, under the new privatization regulations governing the trade sector, retail outlets (rented premises) with less than ten employees had to be sold. This loss of outlets directly entailed a drop in sales and job losses, and 30 people had to be made redundant.

[17] Carried out by János Hovorka.

Again, in March 1991, indications of a decline in sales led the management to reduce costs in order to maintain the profitability of the firm. As a result, and despite the grave economic situation, Amfora once again returned to profitability. At the beginning of the 1990s, its assets were growing, and the company was in a sound financial situation.

4.2 The introduction of employee property notes

Amfora first introduced employee property notes in 1986. At that time, the procedure was illegal and the project failed. In 1989, a plan was once again developed to transform the firm into a joint-stock company and hand out free employee shares. The company set aside for this purpose HUF35 million from its 1989 after-tax profits. However, the transformation could not be carried out in 1990 and the HUF35 million were therefore distributed in the form of free property notes. A first series of property notes was distributed to employees at the end of 1990 and a second a few months later. For this second series, the firm issued property notes to the value of HUF5 million, to be sold to employees under preferential conditions, with a maximum value of HUF300,000 per person.

In order to provide legal justification for this process, the management put forward several arguments in favour of free property notes. The Amfora *Journal* cites the most important: "It makes the employees the owners of the company and they become directly interested in profits, since their dividend depends on them. If their work contract is terminated, the repayment at face value increases their financial security".[18]

The cash equivalent to the property notes (a total of HUF70 million) remained with the firm, which could decide how to spend it. The firm relies primarily on short-term credits, and by drawing on the 70 million it is able to speed up the repayment of both the principal and the interest.

4.3 Rules governing the distribution of property notes

The rules established by Amfora for the distribution of property notes specify that only the active wage-earners in the firm, and not pensioners, may receive them. However, free property notes were distributed to employees who, after reaching pensionable age, were still employed at the firm. The amount distributed depended on the length of employment. A lump sum of HUF20,000 was given in the form of property notes to employees who were on maternity leave or military service.

The shares of individual employees were mainly determined by their seniority in the firm and their average wage. The calculation was based on income brackets (see table 9.2), with each HUF100,000 of wages being increased by 10 per cent for every year in employment. Seniority thus acted as a linear weighting factor (see in table 9.3 the distribution of the labour force by seniority).

[18] *AMFORA Journal*, Feb. 1991, p. 3.

Table 9.2. Distribution of property notes (first series) by income bracket, Amfora, 1990

Wages (in HUF '000/year)	No. of employees	Value of property notes distributed (%)	Average per employee (HUF)
Below 100	358	14.0	13 687
100-200	520	52.0	35 000
200-300	69	13.2	66 957
300-400	26	7.1	95 577
400-500	14	4.4	110 000
500-600	8	3.4	148 750
600-700	5	2.6	182 000
700-800	1	0.7	245 000
800-900	—	—	—
Above 900	4	2.6	227 500
Total	1005	100.0	34 826

Source: Amfora documents.

Table 9.3. Distribution of employees by seniority, Amfora, 1990

Number of years at the firm	Number of employees
1-3	247
4-8	248
9-15	191
16-25	209
More than 25	110
Total	1 005

The rules for property notes attempted to limit differentials between individual workers. The rules for the first series of free property notes stated that no employee should obtain more than ten times the per capita average. This does not mean that 30-fold or even large differences may not arise. Indeed, employees in the lowest category obtained first series property notes to the value of HUF9,000, while those in the highest category obtained notes valued at HUF368,000 (see averages in table 9.2).

In addition to the free property notes, each employee could purchase property notes to a maximum value of HUF300,000 under preferential conditions from a fund of HUF5 million notes. Members of the Enterprise Council and the managing director of the firm were obliged to buy property notes. Voluntary buyers mostly consisted of high-ranking (and high income) managers. Other categories of employee were not very interested, even though notes which were purchased gave a higher fixed dividend than other forms of investment. The dividend on purchased notes was also different from the dividend on free property notes. While the dividend

on free notes depended on the annual ratio of taxable profits, the dividend on purchased notes was fixed at a rate of 2 per cent above the interest rate obtained from deposit certificates of the National Savings Bank. Nevertheless, the second series of property notes, despite a prolonged subscription period, enjoyed only limited success and was not sold out.

Apart from the method of calculating the dividend, the other conditions are the same for both types of property note. Purchased and free property notes are named and endorsable only within the firm, among the employees of the firm. The firm buys back property notes at their face value if the work contract is terminated or if the worker dies. In this latter case, the heirs obtain the cash equivalent of the property notes.

In comparison with the first series of free property notes, however, slight modifications were introduced in the second series of purchasable notes. In particular, income brackets were narrowed and the amount of property notes attached to individual brackets was reduced for the lowest brackets and raised for the highest, thereby leading to increased differentiation. The distribution of notes was based on 1990 annual wages.

The share of each category of worker in the allocation of property notes was more or less the same for the two series. The per capita average for both series was around HUF35,000. For the second series of property notes, the lowest category of workers could obtain notes to the value of HUF16,800 and the highest category HUF287,500.

4.4 The conversion of property notes into employee stock

When issuing the first series of property notes, the management clearly stated its intention of converting them into employee stock during the transformation of the company into a joint-stock company. This statement was included in the rules governing both series of property notes.

Amfora was transformed into a joint-stock company in July 1991. Its capital was composed of 79 per cent state assets, 14.3 per cent funds from the Austrian Landesbank and 6.7 per cent property notes. At the general meeting of the new Amfora company, it was announced that on 1 January 1992 property notes would be transformed at their face value into employee stock.

However, the employees do not yet have a real appreciation of stock-ownership. The idea of issuing property notes and employee stock was advanced by the management. The concept was worked out with the participation of trade unions and was accepted by the Enterprise Council. Employees were informed through two channels. The trade union presented the plans to its members and the firm informed the heads of departments about the Enterprise Council's decision through an internal circular. Heads of departments had to inform all employees. The firm's internal publication also provided information on the conditions under which employee shares could be obtained.

For both series of property notes, the various categories of employees have reacted differently. A majority of employees were only mildly enthusiastic about the possibility of stock distribution and clearly stated their preference for cash. They said they would not be interested in employee stock even at half its face value.

In contrast, the managers obtained a large share because they already held many property notes as a result of their managerial position (principally on the basis of their higher wages). They expect to obtain a substantial dividend from their stocks. It was for this reason that they were disappointed when sales came to a halt in 1991.

Conclusion

The example of Amfora illustrates the difficulty of implementing an ambitious financial participation policy in Hungary at the present time. The difficult economic and social conditions limit the possibility for managers to implement payment systems which are linked to profits or other indicators of enterprise performance. The workers, whose real wages have declined since the beginning of the reform process, also find it difficult to acquire shares during the privatization process.

However, recent legislation and government action to promote various forms of workers' share-ownership and provide credit facilities to help employees participate in this process may result in the development of financial participation, as illustrated by the recent growth in the number of ESOPs in Hungary.

Nevertheless, the need to reduce the public deficit may also induce the Government to give priority to other privatization options. For example, the maximum level of preferential employee share-ownership was cut from 15 to 10 per cent by the Property Policy Guidelines adopted by Parliament in 1992. Recent proposals to issue coupons to all Hungarian citizens in order to accelerate the privatization process are also significant, although in some cases they may further limit the development of workers' share-ownership, as well as other forms of economic democracy. Trade unions will probably have a balancing role to play in this respect. Their recent interest in workers' share-ownership, especially as a way of increasing workers' participation in strategic decisions, particularly as regards employment and lay-offs, is a promising trend. The increasing popularity of management buy-outs is also an effective means of helping small enterprises to maintain employment levels and become profitable. However, further experience is required to be able to evaluate the social and economic potential of this policy and achieve a better understanding of how it can be efficiently combined with other forms of ownership.

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Workers' financial participation: East-West experiences

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