The State and SOEs in Hungarian Privatization

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The Hungarian privatization process can be characterized as a conflict between State-owned Enterprises and the State itself as represented by the State Property Agency. To the extent that prior to privatization, SOEs had to be renationalized, the process itself remains full of internal contradictions. The outcome of that conflict is uncertain, and it is not yet clear how far the extensive powers of enterprise managers appointed by the previous regime will be curtailed.

Foreword

To describe the transformation of the Hungarian economy from the Stalinist to market model is not the purpose of this discussion today. For one thing, the final outcome is some time away and it is not at all certain whether Hungary will follow the North American or the European style of capitalism, or come up with yet another model. It is also too early to judge whether the Hungarians -- or indeed any of the former socialist bloc members -- are going about economic transformation the right way. Rather, it is my basic premise that the most important and effective structural reform for Eastern Europe is ownership reform. Which is to say that the structural and transitional problems which these countries are experiencing are rooted in the false property right distribution and the predominance of the state-owned and administered economic sector.

The fact is that all of these countries are embarked -- or are about to embark -- on a historic journey, one for which there are few blueprints and a variety of conflicting guidelines. However, all agree that privatization is an essential element in dismantling the command economic system and for getting the market place into operation. Again, there are various ways that East European countries are seeking to achieve this process. For we have to emphasize that privatization is not an end in itself, but an essential process in economic transformation. The

methodology to achieve this economic redistribution will influence the economic and social life of these countries for some time to come.

Which is why today's topic, The State and Enterprises in Hungarian Privatization, is of major importance. However, I would like to qualify my remarks to some extent. The fact is that Hungarian privatization is in its beginning and it is extremely difficult to draw definitive conclusions about its strengths and weaknesses. That task will be left up to the historians and students of this part of the world. It is far too early to make judgements.

Nor is it my aim today to tout the successes thus far of Hungarian economic transition and transformation. Indications are favourable and the process in Hungary leads all the other transforming countries in the area. According to the State Property Agency's annual tally, by the end of 1991, more than 10 per cent of the Hungarian economy passed from state to private hands. In addition, a majority of foreign investment going to East Europe -- so crucial to the transformation process -- found its way into the country. All in all, to date roughly a quarter of Hungary's 2000 state-owned enterprises have at least started on the process of privatization. These are facts which speak well for the country, its people and its leadership.

However, what I would like to explore today is the very nature of the privatization process. Specifically, how does the Hungarian process differ from those in the area and perhaps more specifically, what are the dynamics between the state and the state-owned enterprises of today. Being a member of the State Property Agency, I would have to confess a certain amount of bias, though as my conclusions will indicate, I have many questions about the role that we play in the process. However, students of East Europe should not feel uncomfortable with the ambiguities since in this part of the world appearances are often deceiving and many things are not the way they appear to be.

But to arrive at my goal, I would like to take a slight trip back into the recent past which may be familiar but which is necessary.

Role and Expectations of Management

The relationship between the state and state-owned enterprises (SOEs) in the command-economic systems of Eastern Europe has been a complicated one. Perhaps none more so than in Hungary.

The wholesale nationalization of private property during the 1940s and 1950s left almost the entire economy in the hands of the state. In most cases, appropriation of private property included even very small retail outlets. Wholesale

collectivization of agriculture proceeded in fits and starts and was completed after the 1956 uprising. In fact, Hungary followed the Stalinist blueprint of the Party control of the means of production -- as well as distribution.

As has been written by many observers of the socialist bloc, by the 1960s the command model was losing steam. To a greater and lesser degree, several members of the bloc began to experiment with reforming the system. We all know about the Hungarian NEM, introduced in 1968 and continued more or less until the political changes in 1989-90. In fact, Hungary was the only one in the bloc who never completely retreated from its reforms but continued to try to implement them as much as it was possible given the pressures from Moscow and fellow bloc members.

The crucial aspect of the NEM for us here today that Hungary has attempted to reduce its centralization of the economic decisionmaking by putting more decision-making on the production levels. Critics of the Hungarian reform process point out that this meant that instead of formal control mechanisms the system became a kind of "bargaining" style between enterprise managers and the ministries. For our purposes, this has had the results of making the relationship with the centre more uncertain, but at the same time, more flexible as well. In other words, plant managers had to become more flexible and creative in order to keep receiving their accustomed bonuses. Which, of course, did

not necessarily mean that this flexibility was towards the consumer. Quite the contrary. In effect, plant managers became closely intertwined with the political apparatus. Thus, the circle closed and in Hungary, as a result of the various attempts at decentralization, these managers secured a preeminent position for themselves. But as Kornai, among many others, observed:

> "...let us not harbour illusions: the manager of a state-owned firm is not an entrepreneur. There is no getting away from the fact that he, like the heads of other state institutions, is out to expand his spending limits as far as possible. The manager of a state-owned firm also wants to invest more, obtain an ever greater amount of hard currency, import more machinery and equipment from hard currency markets, travel more and let his colleagues do the same; and of course he wants to pay higher wages since this will boost his popularity among the employees and thereby ease the tensions around him." (János Kornai, Socialist Transformation and Privatization: Shifting from a Socialist System. p.281)

Having said that, the 1968 reforms have made it possible for a certain amount of entrepreneurship -- or more specifically, "intrapreneurship" -- to exist in Hungary. The bureaucratic obstacles remained, but within industries developed the so called "autonomous groups within the firm" known as VGMK. These groups could contract out from their workplace piecework production for

which they would be able to earn many times their normal salaries. For the enterprise this had the effect of more efficient use of existing capacity. For the workers, in addition to an increase in earning capacity, it served to keep the creative entrepreneurial spirit alive.

It is suggested here today that in Hungary, in fact, the economic players gradually gained a certain amount of independence from the communist party while becoming a part of the political apparatus. Many Hungarians today consider that economic managers became the backbone by which the state apparatus continued to maintain its power as they strived for more and more say in the country's direction.

A major step in this direction was the introduction of the Law on Enterprise Councils in 1984. While it was designed to further decentralize economic decisionmaking, and ensure production sensitivity to the consumers, it had the effect of making production units almost independent from the ministries and, hence, from the party. Within the factories -- as in the Yugoslav experience -- it was not too difficult for management to assume control over the enterprise councils since, according to the law, half their membership was appointed by management. Within a few years, 70 per cent of State-Owned Enterprises (SOEs) were managed by these councils, thus by the managers. To underscore the point, János Martonyi, privatization commissioner

in 1989 stated:

> "The most important Hungarian peculiarity...is that in Hungary, in 1984 a very peculiar situation was brought about and this may be called semi-privatization, the essence of which is that where the majority of enterprises are concerned, the state -- while maintaining an abstract right of ownership -- entrusted the huge majority, virtually all, entitlements derived from this ownership to the enterprises. The result has been that since then these enterprises have owned themselves. The state believed that this ownership right would be practiced by self-governing enterprise councils. This was not what happened: the practice of ownership slipped from the very first moment into the enterprises..." (János Mártonyi, Hungarian Quarterly, Spring 1990)

The next step was enacted on January 1, 1989. The Law on Business Associations included provisions for converting SOEs into joint stock and limited liability companies. The lawmakers did not anticipate the conversion of state assets into private ones, but the law allowed enterprises to found such corporations which provided the legal loophole for what has become known as "spontaneous privatization" in Hungary.

The essential steps for converting political into economic power

have been described at length and need not be repeated here. Sufficient to say that a number of SOEs became emptied shells in a short period of time. Managers, by the virtue of controlling enterprise councils, became the new entrepreneurs in a changing political system.

The Law on Transformation of SOEs, passed in May 1989, further helped the spontaneous privatization process. According to some estimates, some 100 large enterprises thus slipped out of the state hands, representing a substantial part of the economy. This represented a straight transfer of state assets into private hands without compensation. Another result was the so called "emptied" SOEs whose assets were not strictly appropriated by individuals, but were transferred to beyond the reach of the state.

Specifically, an SOE manager could form, let's say, three limited liability companies and divide company assets among them. For each, he could find a foreign investor who would become majority shareholder of these limited companies. The manager would become head of a holding company with little to do but collect fees and dividends and assure himself the appropriate bonuses. The state thus has become a minority shareholder with little leeway to make its own decisions about how it wanted to use its assets. Yet another difficulty that arose with this type of privatization was that the spontaneous model did not attract the strategic investor

that Hungarian enterprise needed. Rather, according to critics, it attracted the "fast buck" artists who were in it for the quick turnaround.

One aspect of the 1984 and the 1989 laws was to make enterprise managers de facto owners of state assets. Enterprise councils reported to no Board of Directors or stockholders. They had to bargain with the state for investment capital, but their success did not depend on the viability or the profitability of the enterprise, rather, on the political connections of their managers. Since the state also undertook to underwrite enterprise losses, there was literally no control on investment, spending or production by SOEs. Management was able to pay itself huge bonuses without any regard to the viability of the enterprise, which could be then used to buy the enterprise using the spontaneous privatization loopholes. As one observer put it in 1990:

> "We faced an atomized economy, in whoever just happened to hold the marshal's baton, not received on the grounds of ability but handed down from above, was the master of the enterprise, privatized the given assets. (István Csillag, Hungarian Quarterly, Spring 1990)

One of the outcomes of spontaneous privatization, furthermore, was that enterprise managers could now become de jure owners of

state property as well. To sum up, spontaneous privatization is thus a process whereby political capital is converted into economic power and ownership.

We should not forget that this process whereby enterprise managers consolidated their power over a large sector of Hungary's economy did not occur in a political vacuum. Decentralization of economic decisionmaking and economic reforms are basically incompatible with the centralized nature of politics. It has been argued by observers of the Soviet Bloc that, in reality, fundamental economic reforms would result in the loss of Party power. Consequently, as we have seen in the more recent Soviet example -- prior to its collapse -- only gentle tinkering with economic reforms would be possible. Otherwise, as we may judge by the events of Tiananmen square, the Party may have to take drastic measures in order to attempt to reestablish its authority.

In Hungary, as one observer noted:

> (in the autumn of 1989) The state-socialist economy, criticized for decades as too tightly controlled by the state, now found itself in a situation where the already fuzzy lines of control were spinning from ambiguity to near dissolution. In such circumstances, enterprise directors, as the most powerful agents in that economy, could act with unparalleled independence. Their most decisive actions were

> in the new area of privatization.(David Stark, Privatization in Hungary: From Plan to Market or from Plan to Clan? p.364)

Furthermore, the laws passed in 1989 did not foresee the political changes to come, nor the consequent economic transformation that would be necessary.

In Hungary, by the early 1980s the economy was in serious difficulty and the Kadar regime was losing control. Extensive borrowing from the West served to keep the population's standard of living from deteriorating, but did little for solving the problems of declining production. By 1982, the government came within an inch of having to reschedule its foreign debt. We may recall the implicit deal of the Kadar government after 1956 which asked that the people not question its legitimacy and in return it would deliver a better living standard. In the 1980s the party was unable to deliver without huge western loans. As a result, unlike in the rest of the socialist bloc, political transformation in Hungary was not gained by public pressure or force, but was essentially negotiated. However,

> "the specifically political vacuum of mid 1989 was not a legal vacuum, and ... the negotiated transition of political power was not a negotiated transition of economic power." (David Stark, p.262)

Which is to say that the more difficult part of the change process, economic transition, was still outstanding. Clearly, the appropriation of state assets via spontaneous privatization was unacceptable to the transitional Németh government. In addition, the extremely high per-capita foreign debt made it imperative to sell state assets rather than redistribute them. The newly elected government of Hungary thought of privatization as a way of balancing Hungary's budget as well as to use it to repay foreign debts.

However, with the state assets slipping away through spontaneous privatization, soon there might not be any assets to put on the market. Through this peculiar process -- which in Poland was appropriately called "nomenclatura privatization" -- managers and their political allies would be able to secure themselves preeminent positions in the new system.

The Role and Expectations of the Workers

However, before we get into the Hungarian solution to privatization, we should take a look at the role of the workers in this equation. We must remember that the Communist Party ruled in the name of the working class and -- while the ideology has lost its legitimacy -- it created an expectation of participation and equality among workers. As a result, employees have become competitors with the state for claims on state assets since, in effect, privatization was in conflict with enterprise councils.

While it was generally true that these councils were dominated by enterprise managers, workers still felt that they too shared ownership in their place of employment -- at least as far as any division of assets were concerned. Consequently, any realignment of the propriety of state assets would have an immediate impact on worker expectations. In other words, they expected a share in the privatization process. To some extent, that is a primary reason why in Poland, for example, the government has decided on a distributive privatization scheme for a large part of the economy. While in Hungary this was not to be, still, worker expectations would have to be dealt with.

In addition, for over 40 years, workers looked at employment as

an inherent right. Hungarians especially have some long historic reaction to unemployment as being equivalent to extreme poverty and beggarness. Consequently, since any economic rationalization would certainly mean the reduction in the work force, workers have a vital interest in -- and fear of -- the privatization process.

An especially interesting and explosive issue is the privatization of union property. During the communist era, unions served as a transmission belt from below to the party, as well as providing social amenities to its members. To be sure, these amenities were often used as the means of social and political control, but that is another issue. In any case, unions, organized along company lines, became operators of extensive holiday resorts in some of the most desirable parts of Hungary.

The difficulty is that often these properties were carried on the company's books -- as much as these books could be relied on. Consequently, when companies are sold to investors, unions often protest that their members' property is being along with the company. It is not certain in most cases whose property is being actually sold and the fact that the old unions were largely replaced by new ones further complicates identification.

In order to deal with the existence of the Enterprise Councils,

the government decided that those corporations which were previously under worker management, could participate in a modified type of Employee Stock Ownership Plan (ESOP). According to this program, 20 per cent of the income from privatization would have to be rolled back into the company. This served two purposes: one, to strengthen the company's cash flow, and two, part of the money would be used for allowing employees to purchase up to 10 per cent share at a reduced cost.

Thus the paradox and contradiction: politics of envy which desires state regulations, vs being fed up with the excesses of state intervention and the totalitarian power of the bureaucracy. Specifically, on the one hand Hungarian workers continue to expect the state to protect them from the ravages of unemployment and to level out somehow the inequalities in economic power that are beginning to emerge. On the other hand, they have become exasperated up with state and bureaucratic intervention during the last 40 years, and want them out of their lives. This contradiction has allowed political opinions ranging from classic liberalism to strict statism to exist and draw a modicum of support from the voters. This range of sentiments often becomes preoccupied with privatization policy and practice which makes the work of the privatization "watchdog" rather fascinating.

The State Property Agency

Given that there was a policy decision to be made about who really was the owner of the economy, there were two possible choices: first, privatization from above, which implied that the state would renationalize the assets before sale or distribution; or privatization from below ("spontaneous privatization") implying that the enterprise's workers and management were the effective owners. In Hungary it was decided that,

> "An economy starting out from a centralized system should make a great effort to prevent ownership rights from being assumed by firms' managers and workers in an early phase of reform, by defining ownership rights clearly and assigning them as rapidly as possible to agents or institutions outside the enterprises." (Stanley Fischer and Alan Gelb, Issues in Socialist Economy Reform p. 11-12)

Consequently, as a way of establishing a clear line of ownership of state assets, the government created the Hungarian State Property Agency.

Instituted March 1, 1990, (as a part of the Transformation Law of June 1989) the SPA is designed to exercise ownership rights over state assets in the course of reducing the state ownership of the

economy. Specifically, the State Property Agency was charged with the management and utilization of state assets with the aim of facilitating and regulating the privatization of state firms. Unlike other former socialist countries, Hungary placed its main emphasis on selling state-owned enterprises to strategic investors.

The State Property Agency is an organization that performs public service and is a legal entity. The Agency is managed by the government and is charged with the responsibility for exercising the state's ownership rights pertaining to state-owned assets managed by the Agency. The Agency gives account of its activities to the National Assembly or its committees that deal with issues related to the SPA's activities. The activities of the State Property Agency are supervised by the National Auditing Office and are managed by an 11-member Board of Directors, the chairman and members of which are appointed by the Prime Minister. The Managing Director of the State Property Agency, who is in charge of its day-to-day affairs, is appointed and can be recalled by the government.

In November 1991, the Prime Minister appointed a full-time minister of state responsible for privatization and promised to bring to Parliament its long-awaited privatization policy. The legislation, at this writing, has still not appeared.

In the State versus the SOEs conflict, therefore, the State Property Agency was appointed to represent the former. Various vested interests, left over from the former regime -- such as the enterprise managers -- saw their powers seriously threatened. However, they were faced with the realities of a loss of markets, removal of state subsidies and the legislative power of the SPA.

It was recognized early that East European SOEs needed four things desperately: new and up-to-date management, injection of capital, new technology and new markets. The last one was especially crucial since the COMECON market collapsed and the country's largest trader, the Soviet Union, became increasingly less able to pay. And, of course, Hungary needed the income from privatization to reduce its debts, repair its infrastructure, recapitalize its social welfare system and so on.

In order to facilitate privatization the SPA developed specific programs. Among these are investor-initiated privatization and the simplified self-privatization programs. The former is designed to help investors find and purchase state assets. The latter serves to "privatize privatization" by taking the bureaucratic machinery out of the process and help state-owned enterprises privatize themselves. At the same time, the SPA fulfils its role as a protector of state assets by ensuring a fair return for the properties sold to private investors.

A second important task of the SPA, the management of state assets, has been a difficult problem from the beginning. The Agency is the holder of a variety of share portfolios of privatized SOEs as well as of enterprises whose majority or minority shareholding was sold to investors. To date it has not been decided what exactly the SPA was to do with these state assets. Placement on the stock market is problematic due to its poor performance and to the high inflation rate in Hungary. Most of these shares are years away from declaring dividends -- if ever. There is also little experience in the country with this type of asset management, nor are there financial vehicles to deal with them. A partial solution may be the Hungarian Compensation Law which reimburses people's lost property with privatization vouchers. These will be issued starting April 1992 and it is hoped that voucher recipients will trade them in for company shares. However, this is far from certain. Therefore, it is likely that the state will remain a substantial shareholder in the privatized sector for some time to come.

In the new legislation, the government is expected to create a list of SOEs which will not be for sale, or for which it will only allow minority participation. The management of long-term government assets will be handed over to a holding company for which the privatization new minister will also be responsible. Perhaps some clear direction as to where the government wishes privatization to lead will be defined as well.

At its beginnings, the founders of the State Property Agency envisioned a totally different organization than it has turned out to be. Spontaneous -- or company-initiated privatization -- would remain the primary method by which state assets would be placed in the private sector. In addition, the SPA would be a compact organization that would also identify "packages" of high-profile and relatively successful enterprises, incorporate them and place their shares on the fledgling Budapest stock market. Hence, in September 1990, 20 leading enterprises were announced as the First Privatization Program. Soon afterwards, a group of so-called "emptied" SOEs were to be included in the Second Privatization Program. Consideration was given for subsequent programs aimed at selling corporations in the building and wine trades.

Several things went wrong. First, the SPA was not prepared -- organizationally nor financially -- for these programs. Hungarians -- as other East European governments -- came to realize that selling state-owned enterprises was not going to be quick nor cheap. Donor funding would have to be mobilized to facilitate the incorporation of these SOEs (which included valuation, setting books in order, auditing, etc) to pay for expertise which could only be found in the West. In addition, the stock market, which had about 10 listings at the time, could not absorb a large inflow of shares. While the SPA was dealing with these problems, the selected corporations' financial

situation was deteriorating and the Agency found itself in a position of trying to sell assets whose value was changing constantly. The result is that after nearly two years, none of the First Privatization Program enterprises was sold. The program privatization methods was abandoned entirely in late 1991.

It became obvious that enterprises would have to be incorporated and sold one at a time and the process would be long, costly and complicated. The SPA organized itself along industrial lines with case officers dealing with a number of firms. At this point in time, the average case load is 35 SOEs. Not surprisingly, the Agency is suffering from high staff turnover resulting from burnout. It is expected that by the end of 1992 -- due to World Bank funding -- the staff of the SPA will reach 301, or double from its present number. This complement bears a comparison with the Treuhand which has a considerable amount of financial resources and a staff of around 3000.

The achievements and speed of Hungarian privatization are unique. During 1991 the SPA approved the transformation (or incorporation) of 189 companies with a book value of HUF 316 billion,($4.2 billion) revalued at HUF 418 billion ($5.6 billion). [(By comparison, in 1990, 27 enterprises were transformed with a book value of HUF 26 billion ($340 million), revalued at HUF 41 billion.($540 million)] The intensity of the

process is indicated by the fact that transformation and privatization have begun by one-half of the 2000 enterprises at the beginning of 1991. The 1991 income of the SPA (realized either in forints or in foreign currencies) exceeded HUF 40 billion ($533 million).

One problematic aspect of 1991's privatization income is that 85 per cent was in terms of foreign currency. Which means that Hungarian entrepreneurs are only a very minor part of the privatization process.

The result is that, from 90-per cent state ownership in 1989, at the end of 1991, less than 80 per cent of the economy operates under direct government control. Twenty per cent of the previously state-owned property, at a book value of HUF 370 billion ($4.9 billion), is in corporate form with at least 50 per cent of it controlled by the private sector. To date, over half of all foreign investment in the former socialist bloc has come to Hungary, out of which approximately 60 per cent have been to transformed or privatized enterprises. The rest has come in "green field" investment or in joint ventures with already private corporations.

Enterprise managers and liberal economists are critical of centralized privatization. They contend that the old ministries' power was handed over to a new "Ministry of Ownership" and that

the SPA is really a continuation of centralized ownership and control. The Agency, after all, is an arm of the government and its process has remained a highly centralized one. The government is not the best agent for privatization, rather, the process itself should be privatized. Being a proprietor of state assets as well as its agent for state divestiture, these roles may represent a conflict of interest. And in the final analysis, the SPA may in time develop an interest of its own and may turn out to be a powerful bureaucratic agent pursuing its own survival interests. Others are concerned that the Agency may become an arm of the political party in power. And so on.

Defenders, however, point out that it is not the Agency's task to accumulate, but rather to dispose of state assets. If the SPA was not created to control spontaneous privatization, there might have been little property left for the new state to transform in a rational manner. Furthermore, the SPA makes every attempt to keep transparency in the forefront of the privatization process. Most sales are tendered out publicly even in cases where an SOE finds a foreign partner willing to enter into a joint venture.

While the achievements have been significant, the process has been more complex than previously realized. There is much to be learned and applied to future programs and transactions if the government's target of having 70 per cent of the economy in private hands by 1995 is to be realized. In the context of our

discussions today, however, we can differentiate between the Hungarian treatment of enterprise managers from that of other former socialist countries. In Hungary, the state -- that is the SPA -- sought only to change ownership of state assets; it did not seek to purge or remove the existing managers. In fact, the mandate of the SPA does not include the management of state assets. Nor can it remove managers without political repercussions even though it has the power to do so.

Some of the large investors in Hungary so far are: Sanofi, United Biscuits, General Electric, Electrolux, Nestle's, Siemens and Philip Morris. In addition, General Motors of the United States and Suzuki Motors of Japan have invested in green field enterprises in Hungary.

The Lehel Example

In March 1991, Electrolux bought 100 per cent of the Hungarian Lehel frigidaire manufacturer. The workers, unions and the local government were all concerned that the new capitalist owners would put an end to the social amenities they have enjoyed for decades. In the event, however, the plant skating rink, bowling alleys, kindergarten, creches and holiday resorts are being maintained by Electrolux. The one exception is the company zoo, complete with lions, which the company offered to the local government as a gift.

Lehel was founded in 1952 and developed its cooling equipment product profile in 1964. Unlike most Hungarian manufacturers, it has turned a profit even in the 1980s; however, by 1989 it found that it needed capital in order to maintain its market share and therefore began to look for foreign partners. Based on a long-term relationship with Electrolux the company sought to sell them a 26 per cent share. However, in August 1990 the SPA intervened and took Lehel under its management.

At that time, it became obvious that Electrolux wished to purchase 100 per cent of the company to which the SPA agreed, thus paving the way to the first outright purchase in Hungarian privatization.

The Swedish company examined its acquisition and chose to concentrate on the manufacturing of frigidaires. Due to the collapse of the COMECON market, Lehel was undergoing a decline in sales even before the purchase and, as a result, about 800 employees from a total workforce of 4800 have since left the company. These redundant workers received very generous severance packages by Hungarian standards. Most of those who left voluntarily were manual workers who, according to reports, felt that it was a matter of time before they would be laid off in any case. By contrast, according to a company spokesman, Electrolux had no intention of reducing its workforce, but has laid off about a third of the lower-level administration instead.

During 1991, workers have received a pay increase averaging 40 per cent, a half of which was due to the company's intervention.

One concern the new company has is the environmental damage caused over the last four decades. Its cleanup will be at the expense of the purchase price which was kept confidential by the SPA. (extract from Magyar Nemzet, February 19, 1992)

Privatization: some conflicts and challenges

Speed & simplicity

In the heady days after the political transformation, East European governments, Hungary included, considered privatization of state assets to be a high and immediate priority. However, their thinking did not take into account the complexities and costs of the privatization process. Indeed, the latest pronouncements coming from the Russian Republic about privatizing everything within six months or so is reminiscent of East European expectations circa 1989-1990. Since then, it has become obvious that the condition of the SOEs and the lack of experience in privatizing them under these circumstances makes this a lengthy process. In addition, in order to prepare SOEs for purchase has proven to be extremely costly as well.

To give some examples: many state corporations have little idea of their capital resources. Office buildings, warehouses and other facilities were routinely given out by the ministries or exchanged with others. Consequently, an inventory of assets is often necessary before the SOE can be incorporated. And of course, we need not dwell upon the problems of Soviet Bloc bookkeeping. Suffice to say, these have to be updated to Western standards before the companies can be incorporated and sold.

In Hungary, due to the inability of the SPA to bring these problems and complexities to the general consciousness, the population is impatient with the speed of privatization. That is, they want it to go faster.

Protection of state assets

One of the founding principles of the SPA is the protection of state assets during the privatization process. We may recall that the organization was brought about largely to check and regulate spontaneous privatizations which resulted in state property being transferred into private hands or beyond state's reach. However, there are some substantial limitations to a complete protection.

First, according to the SPA's charter, transactions under HUF 30 million (about half million dollars US) do not have to be reported by the state corporations. Thus, the company could be sold piecemeal without reference to the SPA.

Secondly, there is the size of the SPA itself. At present it consists of about 150 people and is expected to rise to a little over 300 by the end of 1992. Even if the Agency were so inclined, this is not a sufficient number for policing all the corporations.

Consequently, we may observe an interesting phenomenon which is -- I'm certain -- repeated throughout the former communist bloc. This is a type of slow-motion winding up of SOEs by its employees. A fairly typical example was a construction company I advised during the Fall of 1991 in order to explain to the general manager and his staff the rules of self-privatization. It became evident that almost none of the some 1500 employees the corporation carried on its books -- and continued to pay -- came into work except to pick up their monthly pay. Management continued to pay itself the usual bonuses. The one hitch was that the corporation has not had any work for over 18 months. To pay their wages and bonuses, they rented out the downtown Budapest office bloc which was assigned to the company some time ago, and started selling off or renting out company facilities to the private sector.

According to indications, there are many SOEs in the same situation. They are clearly frittering away state assets to continue to employ themselves. But would it make much sense to throw these companies into bankruptcy and cause massive instant unemployment? Or -- since most SOEs hold each others' IOUs and the banks were capitalized with such paper -- would not the whole house of cards collapse?

Politically, this process is also becoming very worrying. People who are not themselves benefitting from privatization see the

former economic leaders continuing to benefit long after the system is supposed to have changed. According to many, the "old comrades" have become the "nouveau riche" and are sceptical about government willingness to protect their interests. It is difficult to see what the state -- or the SPA -- can do to remedy this situation. Clearly, the type of wholesale changes in leadership by the communists in 1949 is unacceptable in a state of law. On the other hand, if the state is not willing to carry out a wholesale purge, then those with experience and connections in the previous system are bound to remain on top in the new.

Management resistance

The legislation creating the SPA has given it extensive powers but little direction. Once a state-owned enterprise is converted or commercialized, the Agency becomes sole owner of its shares. It can then exercise proprietary control over the company "over the short run" though -- as was mentioned earlier -- it was not given the mandate to manage the enterprise. In certain cases, such as if the company management is hindering the privatization process, the SPA may take the company under state supervision and name a board to manage it.

As mentioned earlier, managers see this as a state intrusion, even renationalization -- which, in fact, it really is. Though some managers are ready and able to face the new challenges, by

and large they are unprepared and often unwilling to lose the position of unfettered power they have enjoyed. Resistance to the SPA is regularly experienced by the caseworkers. Often managers are able to enlist the employees to their side by citing the rate of unemployment resulting from privatization.

Foreign investors are natural allies of SOE management. They too wish to pay as little as possible for state assets and are often willing to consider favourable treatment of existing management in return. The State Property Agency, due to its mandate to get a "fair" return on these assets, is generally seen to be a hindrance to quick sales.

But since the privatization process is difficult to stop, another tactic is to undervalue the company assets in order to quickly sell to a foreign partner, a favourite manoeuvre of the spontaneous privatization era. By this managers hope that the new owner will be more likely to keep them in some responsible position. Since this is contrary to the SPAs mandate which is to get a fair return on state assets, case workers find themselves in constant conflict over company valuations. This is somewhat of an uneven battle since the SPA does not have the manpower to supervise company valuations. Initiating appraisal by the SPA -- on the other hand -- means that it is the Agency who would bear the costs, something which it can rarely afford.

One of the major financial difficulties that the SPA has had from its very beginning is that the Hungarian government was unable to sufficiently fund it to pay for the consultants necessary for the transformation and privatization of SOEs. Donor funding from the World Bank, the PHARE program and USAID have helped. However, by its very nature, donor funding is not quickly reactive. That is, it comes months after the need has been identified and the request winds its way around the funding agency's bureaucracy. Thus, this is yet another factor slowing down Hungarian privatization.

According to legislation, by the end of 1992 all SOEs will have to be transformed. Unless the law is changed, the SPA and SOEs can look forward to a long and difficult fall and winter.

SPA apparatus and lack of experience

As was mentioned earlier, the Agency is under-resourced to carry out the task it was entrusted with. The doubling of its staff in the coming months will alleviate the situation in the long run but will bring about further organizational problems in the coming year.

The fact is that it is almost impossible to find experienced case officers and managers for the organization. After all, the privatization process is a new one and there are no precedents to

fall back on. Consequently, there is no ready pool of expertise from which to choose.

The existing lines of authority within the organization need restructuring. As it is traditional in Hungarian bureaucracy, all authority rests in the hands of the Managing Director and expenditures in most cases are decided by him alone. The Agency, in fact, is far from a modern governmental structure with clear policies and procedures. There is a constant changes in staff and as a result the organization lacks continuity. The SPA, in fact, is engaged mostly in trying to keep up with changes in the political and economic arena instead of providing a leadership role for which it was created.

Its Board of Directors make all the final decisions in cases of transformations and sales and their decisions cannot be appealed. They, in turn, depend on the advice of harried case officers and directors. Since there has been no privatization policy handed down by the government, the Board, in effect, has been making policy in the way of its decisions. Consequently, the SPA has been vulnerable to political attacks from all quarters, from those who consider privatization being too slow, to those in whose opinion state assets are sold at bargain prices. Others are unhappy with privatization proceeds, charging that too much of it is paid to foreign consultants.

The organization has been under attack from the Ministry of Finance during much of 1991 who wanted the SPA to be incorporated into the ministry and, therefore, more of the proceeds could be used to pay off Hungary's external debts. On the other side, a group of Members of Parliament wanted all cases of privatizations reopened in order to see whether the state received its fair returns. Neither of these efforts succeeded and with the naming of a Minister of State for Privatization perhaps many of the political battles will abate.

Structural economic problems

I have already alluded to the problems with auditing and valuation of SOEs in Hungary. These serve to slow down the privatization process as well as making it more expensive than was expected. As well, the resulting uncertainties may be used by enterprise managers to hinder economic transformations and to lay the SPA open to charges of undervaluing SOEs.

Hungary's high inflation rate is also a considerable problem. In 1991 it came in around 35 per cent and according to government prediction it may be lowered to around 25 per cent in 1992. Such inflation rates influence all potential investors, especially domestic ones. At the moment the banks will pay a net earning of around 27 per cent on deposits. This is much safer and better than many other investments. Statistics indicate that Hungarians

hold a substantial amount of local and foreign currency in bank accounts and may be waiting for lower rates before moving them into other vehicles. With consumer consumption continuing to fall, the safest and most profitable investment today in Hungary is a bank account.

But then, in the West, most of investment is financed by credit. In Hungary this is far from being the case. The fact is that banking and the system of credit is very backward. Securing long-term financing is almost impossible. For the small investor there are preferential "existence" and "privatization" loans but these are very minute, around $85,000 maximum. Furthermore, the banks often demand 150 per cent security which cannot include one's place of residence since, in case of non-payment, a family cannot be evicted from its home. Consequently, as we have seen, the Hungarian potential investor is largely left out of the process.

Finally, in this regard we should mention the role of the bureaucratic state apparatus. The legal structures necessary for economic transformation are passed at great speed by the nation's Parliament. Due to the haste, some of these laws are incomplete or faulty. But even if they were sufficient to do the job, they rely on the state administrative apparatus which is a leftover from the former regime and is largely inadequate, inefficient and outdated. Much could be said and written about the shortcomings

of East European bureaucracies. Suffice to say here today that this body is not an ingredient of the solution but a substantial portion of the problem.

Conclusions

In this presentation I have tried to outline and illustrate some of the contradictions and conflicts in the Hungarian privatization process. To list them all would take much more time than there is available here.

Perhaps the most important question in this regard is whether the state has intended -- through its privatizing agent the SPA -- to curb the transfer of managers' power from the old regime to the new. The Agency has managed, to a great extent, to prevent the abuses of the spontaneous privatization era. It has not -- as I tried to point out -- succeeded, at least in the short run, to prevent enterprise managers from continuing to enjoy the advantageous positions they have attained during the communist era. The fact that they have, may become a serious political problem for the government in the foreseeable future.

Essentially, however, there are fundamental problems in the way Hungarian privatization is proceeding which should be mentioned. First of these is that it is a government organization, the State Property Agency, which is in charge of the process. Clearly, a governmental body is not the best one to carry it out, but there may be little choice. It is an advantage in Hungary that the SPA is not a government department as it is in other East

European states which would make it even more dependent on everyday politics.

Secondly, while I think the Hungarian way of privatization -- that is by selling state assets rather than redistributing them -- is the right way, there is the danger that the process will take too long. Redistributive privatization -- such as the Polish or Czech efforts -- has the benefit of getting the government out of the economy fast. It remains to be seen whether Hungary will develop a private sector soon enough which will counterbalance the dangers of continuing public ownership.

Thirdly, it must be emphasized that in East Europe, privatization is a race against bankruptcy. As was mentioned, unviable state-owned enterprises are engaged in slow-motion bankruptcy by selling off their assets piecemeal in order to keep some of their managers and staff drawing their salaries. Obviously, this process cannot continue indefinitely. The question is, when more and more of these employees lose their livelihood will there be a healthy private sector which will be able to employ them? If not, the rate of unemployment may become too much of a political problem for any government to deal with.

Lastly, the resolution of the conflicts between the state and state-owned enterprises left over from a former era can be problematic during the processes of transformation and

privatization. After all, as I have tried to outline here, finding "real" owners for SOEs involves the destruction of the system of close interdependence between politics and economics. It often means the reduction of economic and political power of the enterprise managers who secured their positions largely through their political connections. Given all that, one can expect some stiff resistance to this type of major transformation. What makes it complicated is the ambivalent attitude of the Hungarian government -- and, therefore, the SPA -- towards the former apparatchik. Consequently, it is too early to tell whether we are looking at a major redistribution of state assets or a reconfirmation of its previous administrators.

It remains to be seen that, when all is done and the privatization goals are met, how the state will deal with the resulting private monopolies which are bound to occur in a small country with concentrated industries. But the regulation of the private sector is the subject of another lecture.

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