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THE BACK DOOR: SPONTANEOUS PRIVATIZATION IN HUNGARY*

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The political changes that have swept Hungary in the past few years have been truly revolutionary. However, its newly elected government has not begun comparably sweeping economic transformations through privatization. When the state has played such a dominating role in the economy, privatization of state-owned companies must be the centerpiece to any substantial economic reform (Kornai, forthcoming; Stark, 1990; Tardos, 1989), and yet governmental privatization programs have not moved rapidly in any of the formerly communist countries. We hope to provide a picture of privatization in Hungary in the 1989-1991 period, as it has been experienced by managers and employees in enterprises undergoing privatization. While there are numerous excellent institutional analyses of Hungarian privatization (e.g., Kornai, 1990; Stark, 1990), we hope that this brief description of participants' organizational behavior can provide additional insights into these complex institutional changes. In particular,

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our research with our small sample of companies indicates that in these enterprises (1) there is little substantive distinction between "formal" or centrally-directed privatization and "informal" or spontaneous privatizations save that the formal privatizations have been delayed; (2) the combination of circumstances has led these managers and employees to welcome foreign ownership and direction; and (3) the Hungarian economy is rapidly privatizing despite the slow pace of formal governmental privatization programs.

The enterprise descriptions are drawn from a longitudinal study of economic transformation begun by the three authors late in 1989 (when the American team member was a visiting professor at the International Management Center in Budapest). A sample of six enterprises which represented the three major forms of ownership in January 1990 (state-owned companies, a joint venture between a Hungarian state-owned company and a West European business, and two entrepreneurial companies) was selected. Data collection consists of unstructured and structured interviews, employee questionnaires, and company archival data. Fortunately, all three of these sampled state-owned enterprises were selected to participate in the government's first formal privatization (FPP) program which began in 1990. (Only 20 Hungarian state-owned companies are being privatized in this program.) Therefore, we had the opportunity to become familiar with these organizations before their formal privatizations began and have been able to study the process in some detail at the company level.

Because terms such as privatization and spontaneous privatization have been used broadly in the debates over these processes, we must begin by clearly defining these concepts for this analysis. By "privatization", we mean the transfer of part or all of the ownership of a company to a private profit-seeking person or institution. In Hungary, many state-owned enterprises are changing their legal structure by converting to nominally independent satellites (KFT) or shareholding companies (RT) which remain wholly owned by the state or state enterprises. For the purposes of this work, a company is considered to be "privatized" only when a significant proportion is owned by non-state profit-seeking companies or individuals.

Similarly "spontaneous privatization" has entered the political debate, and it has often become a code word for transactions in which enterprise managers use their positions to construct privatization agreements that provide an unfair personal benefit to themselves – through arranging bank loans for their own purchase of company shares or through contracts with new owners that protect them from

dismissal. What is "fair" under these circumstances can become a very complex and ideologically charged question – one which we would like to leave in the political arena. Fortunately, the cases of spontaneous privatization describe here provided no ownership or job protections for anyone in the enterprises. It is better to describe these cases, and many similar ones, as company-initiated rather than centrally-directed. We believe that a few well-publicized scandals have tainted a manner of privatization that differs, our research suggests, from formal privatization only in its speed.

Before presenting these cases it is necessary to provide a very brief description of Hungarian privatization in early 1991. We then describe the managerial and employee organizational behavior in two sampled enterprises that are participating in the government's first formal privatization program. Next, we provide two illustrations of manager-initiated privatization.

1 Privatization in Hungary

Within Hungary, there is a broad consensus that privatization (in some form) is needed both to increase international economic competitiveness and to attract foreign capital. The efficiency of Hungarian state-owned companies is generally very low: they are characterized by wasteful production, over employment, and poor quality marketing and management (Markoczy, 1990; Pearce, Branyiczki, & Bakacsi, 1991). In Hungary, privatization serves another vital national objective. Hungary has high internal and external debts, and, because the economy is struggling from the collapse of the Eastern Bloc markets, there is little income for debt reduction. Income from the privatization of previously nationalized companies and properties will be used by the government to pay its debts. Despite such urgency, rapid privatization would place a potentially large proportion of the economy in foreign hands – politically an unpopular outcome. Another difficulty facing programs of formal privatization is the inertia inherent in large bureaucracies (Mintzberg, 1979). Many newly elected officials prefer that the state be intrusive, just as it has been for the last forty years. The election was perceived by many as just a change of players. Despite their much publicized intentions, many members of the bureaucracy still encourage the expansion of bureaucracy.

From the government's point of view, rapid privatization by sales to foreigners is a panacea to help cure many of the problems of the

economy. Managers of state-owned companies also consider privatization a panacea, but for them, it is a cure for different problems, including the lack of cash, diminishing markets, and the need for technological development. Many companies consider privatization a redemption or, at least, a source of free investment capital. Because privatization holds great promise, the government is pursuing sales to foreigners through its formal privatization programs (FPP) and joint ventures. However, it does so nervously and slowly.

The State Property Agency (SPA) was established by Law VII.1990 for the purpose of helping and controlling the privatization of the state owned companies. Spontaneous privatizations generated a great deal of debate by late 1989, and the SPA was created, in part, to bring these privatizations "under central control". Thus, the SPA itself has contradictory roles – aiding privatization and limiting privatizations that are not in the interests of the state. Hungary's first formal privatization program (FPP) includes 20 companies and began in September 1990 with an announcement of the companies to be privatized. An invitation was extended to private consulting companies to "bid" for the privatization contracts for each company. A bid was to include the plan for privatization (whether the company would be sold to someone else, whether shares would be offered to the public, plans for company management during the transition, etc.).

2 Centrally-Directed Privatization in Practice

2.1 Company-initiated centrally-directed privatization: The case of the Sheet Glass Company

The Sheet Glass Company produces drawn glass for a wide variety of industrial and consumer goods companies and has almost two thousand employees. Until the Soviet market collapsed in 1990, it was profitable, one of the most successful companies in a northern industrial region of Hungary. Since a large proportion of the company's products were built into goods for Soviet export, the sudden loss of that large market in 1990 caused a serious liquidity crisis. In the meantime, an expensive new investment had just been completed to improve the company's heat-treated special-glass technology. Only with the help of two Hungarian banks did the company avoid bankruptcy in 1990.

To the managers of this company, it seemed vital that an injection of cash and new markets for their products be found, and privatization

seemed to be the optimal solution. The company has substantial capacity to produce marketable goods, so foreign companies from the glass business showed an early interest and began to investigate the possibilities of forming a joint venture or of buying the company. That is, this company was actively seeking "spontaneous privatization" many months before the FPP began.

While discussions with possible foreign joint-venture partners were progressing in mid-1990, another crisis struck: the recently retired managing director was charged with misusing company resources. The top management was replaced, and an investigation of the company began. This delayed progress in the negotiations with foreign partners.

Within a few months during 1990, the Sheet Glass Company received three major blows: the loss of large part of its market, serious liquidity problems, and an investigation of company fraud. These problems demanded much of the new managers' time and caused serious morale problems in the work force. Within this six-month period, production had to be reduced and almost 20 percent of the workers were laid off. These circumstances placed the company in an almost hopeless situation, at the brink of collapse. So, the management group decided to apply for participation in the FPP.

The application was accepted by SPA because the company had had some previous negotiations with possible foreign investors. No agreement had been reached with these investors because the previous managers had been afraid their names would be associated with large-scale layoffs following a joint venture with private owners and they didn't want to deal with the resultant regional outcry. Also, because the company was almost bankrupt, the foreign investor had wanted to buy it for a much lower price than its estimated book value. If the managers had sold the company for such a low price, they would have been suspected of bribery or of trying to keep their positions. The first privatization program of SPA served the managers very well: they could pass the responsibility for the consequences of the privatization to the consulting company and the SPA.

When the SPA opened a tender for consulting and investing agencies to manage the procedures of the privatization of the listed 20 companies in late 1990, more than ten agencies sent bids for the privatization of the Sheet Glass Company. The SPA made the final selection in December 1990. The bid proposed that part of the company be sold to a large multinational glass manufacturing holding company

based in Western Europe. While the government will keep a certain proportion of the shares, that amount has not yet been determined. Unfortunately, delays at the SPA meant that the company still had not been privatized by February 1992. The frustrated foreign company decided to make a substantial investment in Czechoslovakia instead of in the Sheet Glass Company. The company had to conduct another large layoff in 1991, and the loan payments on the previous investments (equal to total labor costs in 1991) have brought the company to the edge of bankruptcy.

The participants' reactions to these events within the company place them roughly into two groups. The first group consists of the very small number of top managers and associated professionals who have been involved in negotiations with possible foreign partners, SPA officials and consulting companies. Because of the need to speak foreign languages, younger professionals with this capability have risen very rapidly in importance. Further, their exposure to negotiations with foreigners (and their ability to take advantage of proliferating management education programs) have led them to learn a great deal about capitalist approaches to company evaluation and markets in a short period of time. They are excited, optimistic, and very overworked. In contrast, the rest of the managers and the vast majority of the employees are frightened and passive. They witnessed the layoffs and know that the company has severe liquidity problems; they know that there are extensive negotiations with ministerial officials and foreigners, but they do not really understand what it all means. Their perspectives are still dominated by "old system thinking" (e.g., complaints that the government doesn't give them enough money to buy better technology). The company has already lost numerous professional employees who feel more secure in foreign joint ventures.

2.2 Government-initiated centrally-directed privatization: The case of the Porcelain Factory

The Porcelain Factory makes fine tableware, figurines and other "collectibles". It was founded by an aristocrat in 1777 on his remote estate near the Slovakian border. This was a "self-governing company", which meant that it was governed by an enterprise council in which employees elect 51% of the members, until its conversion to an RT in late 1991. The council was the highest authority within the company; it could hire and fire all managers and make the strategic decisions.

The Porcelain Factory also faced a collapsed market in 1990. Eighty percent of this company's sales had been domestic, and, with the

decline of the Hungarian economy, the demand for porcelain goods had decreased much more than the demand for basic goods. The company had distributed through state-owned stores and a few of their own shops, so their marketing and the sales activities were under-developed. They are able to produce quality goods which are internationally marketable, but by late 1990 they had a large stock of unsold inventories and a severe liquidity problem.

Prior to participation in the FPP, the Porcelain Factory had had discussions with an interested foreign partner from (then) West Germany. However, the investment bank intermediary dropped the project for reasons unknown to the management. The attractiveness of their products and prior foreign contacts were the reasons why a representative of the SPA contacted the company proposing participation in the FPP at an enterprise council meeting. Concurrently, by the second half of 1990, the company management decided to enter a company transformation program financed by the European Economic Community. The program was directed by a Dutch consulting company, and its primary aim was to address problems related to the company's operations, marketing, and sales activities. The group was to seek potential foreign partners who could provide distribution channels and investment capital. At the enterprise council meeting, the representative of SPA argued that the best interests of the company would be served by its joining the FPP, since any subsequent partnership would have to be approved by the SPA. The SPA could prevent the company from proceeding independently. Therefore, the council voted to take part "by their own will" in the FPP instead of pursuing their previous program with the Dutch consulting company.

After the formal announcement of participation, 17 bids were made to privatize the Porcelain Factory. An international investment banking consortium was chosen by the SPA. This group's proposal is to transform the company into a shareholder company with the SPA owning 100 percent. Then, the consulting company plans to issue an information booklet for possible outside investors. A local governmental authority currently holds a minority interest, but its proportion of the final shares has not been decided. By February 1992 the company had not yet been privatized and had not taken the steps necessary to develop a marketing capability. It continues to lose money in the depressed Hungarian retail market.

The reactions of the employees in this company are complex. This is the only employer of any size within 25 kilometers, so the town is truly a company town. Many current employees are the children and

grandchildren of former employees. In addition, numerous employees are very specialized (e.g., hand painters of porcelain), and comparable housing would be impossible for them to find elsewhere in the country. Thus, the labor force is not mobile, and numerous personal tragedies would result if employees lost their jobs. Their fear is reflected in the enterprise council's firing, in June 1990, of the previous managing director when he proposed trimming managerial positions. To date, there have been no layoffs, yet the growing stockpile of unsold goods worries these highly dependent employees. They are well aware that their current and previous managers have not proactively marketed the company's products. These employees have developed a belief that foreigners will "save" them. For example, in December 1990, while we were conducting interviews at the factory, the announcement was made of the selection of the consulting company which would develop the privatization plan. Many employees were jubilant that "they had new foreign owners" who would now begin to market their products in the West. Only a few of the top managers clearly understood the complex relationships among the various agencies and organizations involved in the privatization.

2.3 Centrally-directed privatization in formerly communist countries

Both of these cases of formal privatization illustrate two features of this process that may extend to other companies and countries. First, early privatization (in the form of joint ventures) was initially resisted by these companies' managers because they feared the political outcry that would follow restructuring and the attendant layoffs. Eventually, however, it had become undisputably clear to these employees that goods being produced were not moving out of warehouses and that new orders were not arriving. The devastating economic collapse of 1990 and 1991 has changed the political environment. By late 1990, these employees and managers knew that their government could not continue to rescue them. Further, they had seen employees' salaries at joint ventures and private companies double and triple. Layoffs were happening with or without privatization, and privatization offered the chance to save some jobs as well as to increase wages. While there are still some state-owned companies in Hungary with managers who do not want joint-ventures or ownership transfers to foreigners, they have dwindled to a minority.

Second, the creation of an additional bureaucratic entity, the SPA, has helped to blur responsibility for the consequences of privatization.

For any FPP privatization, four different entities are involved: the official "owner" (the Ministry of Industry), the SPA (which organizes the procedure for privatization), the private consulting company (which will manage the privatization), and the company management (which is involved in the strategies for managing the transition). If any group of employees tries to exert pressure for favorable treatment, where would they start? Any entity that is the target of influence can claim that it is not responsible. It is particularly important to note that the organization most likely to take public responsibility for any negative consequences would be the consulting company – usually with a complex foreign joint-ownership, which makes it less subject to political pressure.

3 Company-Initiated Privatization in Practice

Despite the fact that the Hungarian government has not yet formally privatized an industrial company, there has been substantial privatization over the last several years. Such privatization can take many different forms. For example, many small professional organizations, such as training companies and advertising agencies, have become partnerships of their members; in effect, the government "gave" these organizations to their professional employees. Such privatization is difficult to track and happens outside the publicity generated by the FPP, so few people know the entire scope and range of all of the forms of company-initiated privatization. However, we will focus on two of the forms that may be less well known to outsiders yet have important implications for the economy as a whole. These are 1) joint ventures between foreign partners and state-owned companies and 2) "employee entrepreneurship" in which state-owned company employees go into business for themselves, often in direct competition with the state companies and while still remaining as their employees.

3.1 Joint-venture privatization: The case of the Elevator Company

The Elevator Company is a large company which designs, installs and services elevators and has about 40 percent of the market for these products and services in Hungary. Until the late 1980s, the company was part of a very large industrial combine which was running debts that were an enormous drain on the government's treasury (due to other companies within the combine). After mounting financial crises (and, possibly, personal conflicts), the government broke the combine into separate companies, prorating the debt among all of them. Thus,

the Elevator Company came into existence in the late 1980s as an enterprise which had a sound core business but a very large inherited debt.

In an attempt to solve its desperate financial problems, in early 1989 top management began to consider joint ventures with a foreign investor. Discussion began with the West European firm with which the company had a licensing agreement. However, a rival multinational elevator company also showed interest in investing in the Elevator Company. When a report of the rival's proposal appeared in the newspaper, the licensing company made an even more attractive counter offer.

The licensing company's proposal was chosen over the proposal of the other multinational elevator firm because it offered greater improvement in technology and more complete services to customers. In addition, the management felt that its fifteen-year association with the licensing company would provide an easier transition. Management signed the letter of intent with the licensing company in 1989, and the final agreement was signed in early 1990.

The joint venture has a complex structure. The West European company own 75 percent, and the original state-owned elevator company, 25 percent. The foreign partner contributed several hundred million HUF, but the money stayed within the company to invest in business and technological development. As part of the agreement, the state-owned company transferred all of its business to the joint venture and agreed not to compete with it. The joint venture then rented space from the state-owned company and hired its best employees. Only a handful of employees remained with the state-owned company, which now does small contract assignments for the joint venture and acts as a landlord. Thus, the large state-owned company is essentially an "empty shell" which owns buildings and a minority stake in its former business.

The Elevator Company was one of the first large companies to be privatized in Hungary, which had an important effect on the employees' attitude toward the proposal. In 1989 the Soviet market had not yet collapsed and few non-specialists realized the extent of the wrenching changes that would accompany economic conversion. The joint venture proposal called for a reduction in the workforce from about 720 to 450 employees (in both the joint venture and the remaining state company). The management of the Elevator Company had numerous emotionally charged meetings with representatives of the trade unions. Finally,

due in part to the persistence of the top managers, they were able to persuade the trade union that the gains for the remaining workers (significantly higher salaries, better equipment and working conditions, and training in Western Europe every other year) outweighed the costs to those laid off. Ultimately, through the use of early retirements, only 100 of the original employees were laid off.

During these transition years, the managers and most employees of the company went through formal and informal programs to learn the standard managerial practices of the foreign partner. Many have spent time working in sister plants in Western Europe. By 1992, their operations, information systems, performance standards and financial and accounting record-keeping systems had to be transformed to make them compatible with those of the new partner.

With the cash and capital injection which came from the foreign investor, the new joint venture is in a good position in several respects. The joint venture is implementing state of the art technologies in conducting research and is using the management procedures of the foreign partner. It has added new services and products. The state-owned holding company is happy with the solution, since more than a hundred people are supported through renting out its state properties. The employees of the new joint venture received large wage raises and better technical and working conditions. Despite the severe recession of 1990-91, the company has retained its market share and hopes to grow rapidly when the economy improves.

3.2 Employee entrepreneurship: The case of the Computer Company

This example of privatization is the most informal and the least visible in Hungary. Yet, we consider it to be a form of privatization, since state-owned companies are using their resources to provide the financial base that allows employees to begin their own businesses. This practice is widespread and involves skilled employees at every level, such as carpenters who work privately at "second jobs" and English professors who translate for foreigners' business negotiations, and so on. While these practices are common in developed capitalist countries, what is unique in Hungary (and, we suspect, in other former and reforming communist countries) is that the state-owned "primary employer" allows the skilled employee a great deal of latitude to conduct private business "on company time". It is an arrangement that benefits both parties. The state-owned employer (actually, the immediate supervisor) can retain a valued employee who would otherwise

leave a shamefully underpaid position. The employee can earn a living and start a business that may become very profitable while retaining the security of his or her primary employment. Because incomes have remained at subsistence levels for so many years in Hungary, few would-be entrepreneurs have savings that can be used to launch businesses. In some cases, such as the one described below, the state employer, in actuality, is a founding "investor" in new companies.

A large Hungarian state-owned computer company had for many years been the monopoly provider of certain kinds of computer services for other companies and cooperatives. The economic liberalization in the 1980s came at the same time as the technological revolution in microcomputers and sophisticated off-the-shelf software. Some state-owned companies and cooperatives began to compete with the Computer Company in certain markets, and many employees left to form their own companies which installed microcomputers and often provided better service than this (former) monopoly. Thus, the company faced twin crises of unfamiliar competition and an accelerating loss of some of its most skilled employees.

In the regional offices, several local directors tried to solve the immediate problem of employee flight by coaxing would-be entrepreneurs to remain with the company. In some cases, they even purchased microcomputers from their own employee-entrepreneurs. While this solution met the immediate needs of the parties, it did take potential business away from the Computer Company and often left "competitors" in the awkward position of providing strategic advice to their state-owned employer-competitor. With the present turmoil about the strategic direction of computer companies, these particular individuals can have a large influence on the state-owned competitor-employer's policies. Thus, the immediate supervisor is solving his or her current need for skilled employees in a way that could potentially undermine the long-term viability of the state-owned company by funding potential competitors and by allowing them to influence the company's policies.

3.3 Company-initiated privatization in formerly communist countries

Centrally-directed privatization is only a small component of the actual privatization occurring in Hungary and, we suspect, in some other formerly communist countries. As company managing directors are allowed more freedom, many naturally turn toward foreign companies which have the distribution channels, advanced technology, and capital that these companies desperately need. Although govern-

ments may wish to restrict and control this company-initiated spontaneous privatization because they feel the companies are being sold "too cheap" (or more likely, because they want the capital for their own treasury), central control has simply added delays which have exacerbated the problems of the two state-owned companies in the FPP described above. Of these three privatizing companies, only the "spontaneously privatized" one has actually received foreign capital and training. By February 1992, nearly 18 months after being selected for this showcase program, neither of the other two had been privatized.

Central direction of such a complex process simply presents overwhelming information processing and political limitations that, in practice, has virtually paralyzed this form of privatization in Hungary. In company-initiated privatization those individuals who have the information (and the incentive) for privatization can proceed with the complex negotiations and analyses necessary to complete the work. It seems to be no accident that the vast amount of foreign investment in formerly communist countries is going to Hungary. There the departing communists began spontaneous privatization in order to provide jobs for themselves; however, they began a process that has made private investment easier. A very contemporary illustration of the invisible hand at work.

Similarly, the overall economy in Hungary is becoming increasingly privatized through the development of what used to be called "the second economy". For many reasons, the official statistics probably under represent the scale of the privatization of labor, with many state-owned companies virtually becoming empty shells. While the government may decry this loss of "its" assets, it may have been unrealistic to expect political agencies with a handful of employees to be able to privatize an entire economy. Probably, it is no more feasible to plan an economic transformation centrally than it was to plan a national economy centrally.

4 Conclusions

When examining Hungarian privatization from the perspective of the managers and employees working in privatizing companies we discovered several aspects of privatization that have not been emphasized in the literature in institutional and policy analysis. First, in our sample there was relatively little substantive distinction between "formal" or centrally-directed privatization and "spontaneous" or

company-initiated privatizations. Unfortunately, to date, the primary difference has been that the company-initiated privatizations have actually taken place and the companies are developing market-focused procedures and policies, while the centrally-directed privatizations remain mired in delays. Second, the economic collapse of the region and visible success of privatized companies have led significant numbers of Hungarian managers and employees to begin to welcome foreign ownership and direction. Finally, the publicized centrally-directed privatization programs represent only a fraction of the actual privatization occurring in Hungary.

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