Inter-University Centre Split/Berlin, Institute for Eastern European Studies, Free University of Berlin

The PEPPER III Report:

Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union

Preliminary Version
Paris Conference
June 29/30, 2006

This Project is funded by the European Union

Preface

The PEPPER III Report has been written by Jens Lowitzsch (Inter-University Centre) in cooperation with a core-team of experts in the field of Financial Participation. It is based on an initial research (Lowitzsch, 2004) supported by the Kelso Institute for the Study of Economic Systems, extended and updated in cooperation with Herwig Roggemann (Inter-University Centre), Milica Uvalić (Perugia University), Iraj Hashi (Staffordshire University) and Daniel Vaughan-Whitehead (International Labour Organisation). The European Commission's Directorate General Employment, Industrial Relations and Social Affairs and the Kelso Institute have supported the extension of the initial project, especially the systematic screening of the concerned countries. The country screening was supervised by three regional coordinators, Iraj Hashi (Balkans), Niels Mygind (Baltics) and Richard Woodward (Central Eastern Europe); the editing of the country reports was supervised by Patricia Kelso and Larry G. Lyon. For individual countries' chapters of the PEPPER III Report, an extensive use was made of the contributions prepared for and made during the Workshop 'Financial Participation of Employees in the New Member and Candidate Countries of Central and Eastern Europe' (May 2005, Split, Croatia), by :

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Extended Country Report

Financial Participation of Employees in Hungary

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2006

A project of the Inter-University Centre Split/Berlin, Institute for Eastern European Studies, Free University of Berlin
Funded by the European Commission and the Kelso Institute - For more information see http://www.intercentar.de

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1. Background

In Hungary employee ownership has been the most frequent form of employee participation. The *'Munkavállalói Résztulajdonosi Program'* (Employee Share Ownership Programme, MRP – by its Hungarian abbreviation, ESOP hereafter), one form of employee ownership based on the US ESOP model spread quickly in the early phase of privatization as a technique in favour of employees to become owners. None the less, the relative weight of this ownership form in the whole of the economy is insignificant, and with privatization over, the number of ESOP companies has been fast decreasing.

With the exception of the 'Approved Employee Securities Benefit Program' introduced by the tax laws in 2003, other forms of employees' financial participation have taken place only to a very limited extent, without any economic policy support – and consequently any proper central registration systems.

a) History

In the researchers' view, 'the current characteristics of employee participation are connected to the 1968 reforms of economic mechanisms and the resulting power relations as well as to the privatization process and regulatory interests'.[1]

(1) Changes in Corporate Governance in the Late-Period State Socialism

Starting with the reforms in 1968 ('New Economic Mechanism') which introduced a set of new elements of incentives and becoming full-fledged in 1984 with the legalization of self-government, 'market co-ordination' (Kornai) replaced the redistributive and bureaucratic socialist economic system as the main economic co-ordination mechanism. Importantly for the topic of this paper, as a result of these reforms the autonomy of state enterprises and the economic power of managers had drastically grown by the time of the political and legal change of the regime and thus could become key actors in the economic transition.

The history of employee ownership

a.) At the beginning of the reform, as an improvement of company's incentive system, profit-sharing was introduced, which became a part of the centrally set wages in state-owned companies. The underlying idea was that this form of performance incentive would encourage employees, primarily managers, improve the efficiency of the company. By the time of the change of the regime, however, the use and size of profit-

[1] From the economic history point of view it is interesting to remember that employee ownership in Hungary began with the Workers' Councils of the 1956 revolution. The idea then was that the state would retain ownership but Workers' Councils would manage the companies and be competent in making strategic decisions including hiring and firing CEOs, selected by competition (Szalai, 1994, pp. 11-12.)

sharing was a matter of bargain between the enterprises and economic regulatory organisations and was used to minimize company taxes and had nothing to do with actual economic performance.

b.) One of the antecedents of employee ownership in Hungary was the Enterprise Business Partnership (VGMK), possible as of 1982. VGMKs were 'intrapreneurial' businesses of core workers in which on the one hand the work organisation was improved through greater autonomy of workers and on the other hand workers could earn extra incomes which helped the companies to retain key employees in the context of labour market competition. (Neumann, 1987)

c.) As an important step of the new economic mechanism, in 1984 the self-government of companies was institutionalised; state enterprises were managed by Enterprise Councils or Assemblies elected by the workers. Transferring part of the ownership rights (from selecting the CEO to making investment decisions) to the these bodies further increased company autonomy – though the actual measure of autonomy depended on the industry, size of the company and other specifications – vis-à-vis the Communist party-state regulation, and put the management in quasi owner position without real control by owners.

(2) Co-operatives

Between the two world wars there was a considerable co-operative movement in Hungary. Credit co-operatives, which financed craftsmen, and agricultural trading and crop manufacturing co-operatives were especially important. The best known of the latter was the 'Ant Co-operative' (*Hangya*), which was set up on the Western model but was heavily centralised in Hungary. Its social base comprised medium-sized landowner farmers, who were also one pillar of the conservative political system of the time. After the communist takeover in 1948, credit co-operatives were liquidated and the rest of national co-operative centres were put under the control of the Communist party and the state and their finances were centralised. In the 1950s and 60s the party state monopolised the ideology and the institutions of the co-operative movement, whereby they could nationalise individual micro enterprises. First the majority of craftsmen, then retail shop keepers were forced to join the communist co-operatives; later farmers with small- and medium-sized lands were forced to join, and by 1960 and 61 practically all of these holdings, created earlier by the distribution of land in 1945, were liquidated.

The artificially inflated co-operative sector employed about one quarter of total employment in the state socialist period. 1st January 1986 14.8% of the nearly 5 million employed were co-operative members (or a 'helping family members') and 8.7% worked as co-operative employees. 69% of co-operative members worked in agriculture, 22% in manufacturing and 5% in construction. With the approaching change of the regime, the rate of co-operative members somewhat dropped, to 12.1% of the total employment in 1989.[2]

In the command economy, co-operatives, just as the state sector, were put under central control and were integrated in the system of institutions of the all embracing central distribution. By 1980, as a result of concentration, giant organisations were created: the management of these hierarchically organised undertakings required considerable professional and managerial skills. For instance, a co-operative with 800 members had 30 to 40 heads with real power. When owing to reforms the autonomy of these enterprises grew, co-operative leaders, formally elected but in reality exercising uncontrolled power, recognised that the assets they were put in charge to manage could be owned by themselves. National co-operative centres, having become the lobby organisation of co-operative heads, had successfully fought for legislation and in the late 1980s the necessary amendments were made that enabled them to use a variety of techniques to formally deprive the majority of co-operative members of their ownerships rights. After dividing up the common asset into small ownership, most of the co-operatives were transformed into business enterprises (limited liability companies or joint-stock companies). In this way the business assets of co-operatives could be privatized and most often finally became owned by co-operative heads. The situation in agriculture was somewhat more complex because land was restituted to original owners or their descendants. So the currently successor organisations of co-operatives most often lease agricultural land from the new owners.

(3) The Privatization Environment

The legal frames of the various forms of employee participation, especially of ESOP, continue to be shaped by the laws created at the time of privatization.[3] Furthermore, the interconnections of the political and social background of privatization analysed in this paper may help understand the behaviour of participants as well as legislation and current policies.

The most important objectives of the centralised privatization policy in Hungary, as opposed to the earlier, legally largely unregulated 'spontaneous privatization', were rapid de-nationalisation, maximizing the (cash) revenue and repaying the state debt, ameliorate the capital situation of the economy and create competitive structures.

While the subsequent governments and their economic policy makers in charge of privatization broadly agreed on these objectives, their emphases were different. Employee-ownership was mostly a societal, justice and equity policy priority thus it could

[2] Statistical Yearbooks, 1987, 1990, Hungarian Central Statistical Office (hereafter: HCSO).

[3] The creation of employee ownership is the result of the special circumstances of transition rather than of the rational operation of organisations in the market economy (Janky, 2002). Their survival, however, is related to usual market economy factors. 63% of companies in management ownership had operated in another form before, i.e. they became employee-owned through privatization (Kovách-Csite, 1999).

only become a realistic option when privatization demand shrank and/or the popularity of privatization seemed intolerably low. With the appearance of mass unemployment in 1991, employee ownership increasingly seemed to be a tool for the company to continue operation and for keeping human resources and jobs. (At the time of mass privatization, especially in the beginning, however, the effects of various cases of transactions were not studied due to lack of routine and shortage of time.) Generally, in the centralised privatization program employee ownership was an option in enterprises that no foreign buyer wanted to buy. These enterprises were successfully privatized with the active help of the management in the frames of some kind of decentralized technique (in the so-called small privatization or self-privatization programmes).

Employees stood a greater chance to become owners in decentralised programs in which individual evaluation of the enterprise as well as the interdependence of company management and privatization advisors ensured a greater room for trade-offs. The newly gained power, due to the law on Business Associations put the company management in an extremely advantageous position both in reshaping the relations between the establishment and the headquarters and in the privatization process. Throughout the whole privatization period as a rule, given the company's inside power relations, no enterprise could be sold against the will of the local management..

In the period of the 'spontaneous privatization', part of the company management became owners. The intransparency of the 'spontaneous privatization' before the setting up of the State Property Agency as well as procedures dubious from the point of view of public asset management and fairness towards employees are the causes of anti-managerial public attitudes and of the political and social illegitimacy of acquisition of company assets by some of the managers (Móra, 1991; Csillag, 1991). It was one of the major reasons why hidden Manager Buy-Out became quite widespread in Hungary.

Another part of enterprise managers lead the movement for ownership by the employee's collective. Privatization of establishments by limited liability companies set up by employees for the buy-out earned public recognition of and support for this kind of ownership. These cases also helped advisors, politicians and interest advocates specialised in employee ownership gain practical experience and strengthen their positions in their own markets.

b) Social Partners

The attitudes of top managers towards ownership and privatization are rather difficult to separate in this historical situation. They supported private ownership as early as in the economic and political debates around the change of the regime.

From the very beginning of privatization they were against centralised privatization. In an organised way, from 1991 under the leadership of the Association of Managers, they urged that a privatization technique should be developed which would favour specifically the management; this they achieved with the legalisation of MBO in 1995.At the same time, managers of primarily small an medium sized companies were happy with techniques of creating majority employee ownership and become owners cheaper and without personal risk and responsibility. Furthermore, the cooperation of managers and subordinates in ownership was in line with the Hungarian traditional intra-enterprise relations. Also, at the price of meeting tough profit requirements, ESOP was a good possibility for the management to preserve their comfortable position gained in the 1980s when they were not required to really fulfil ownership functions (that time some of the ownership rights were exercised by Enterprise Councils and Assemblies made up of company managers and subordinates).

Our empirical study investigating the privatization process found that the main goal of the management in all cases was to keep the whole enterprise (or parts of it that they considered valuable) in one and avoid external ownership control and retain the decision-making autonomy of the management[4]. The importance attached to ownership control is highlighted by the fact that in almost all cases the management wanted majority ownership. They insisted on a majority unnecessarily big for influencing decision-making, and even if majority ownership involved unaffordable costs or unrealistic profit requirements to repay loans.

Similar are the findings of an empirical research by Rozgonyi and Jávor (1996)[5]. The authors emphasize that of the various groups of employees, managers were the most prone to lose their jobs and positions when the ownership or activity profile of the company changed the smallest bit. An important part of employees regarded employee ownership the only acceptable form of privatization in order to avoid foreign ownership.

According to a report of the Hungarian State Audit Office managers most often used the technique of ESOP for buy-out. [6] Their most important motivations were being able to keep powerful positions, earn profits, invest, keep jobs as well as maintain the culture of the given profession and emotional considerations. Fear of existential uncertainty and the wish to prevent buy-out by competitors also played a role (László, 2004).

The outcome of the individual privatization transactions and post-privatization selling, however, can only be understood through the power relations at the given company and the personal ambitions and relation networks of managers. In several cases acquiring employee ownership was a tool to stop a rival manager. In other cases, however,

4 In 1993, on the request of the State Property Agency the findings of an empirical study were summarized. The study covered five early cases of ESOP programs. Selected companies included both profit making and losing enterprises and manufacturers (machine, rubber and plastics and textile industry) and trading companies (agricultural machinery, foreign trade); also, the enterprises were of very different sizes (Boda-Neumann, 1999).

5 Jávor and Rozgonyi researched the employee buy-out in five enterprises with different profiles in 1996. Out of 370 interviewed employees at four companies 202 answered the questions on their opinion and information concerning privatization.

6 According to the memories of a former leader of Rész-vétel Foundation representing ESOP companies, about half of company managers used ESOP as the cover for management buy-out. Half of the rest of the managers realised over time that they did not have to really share ownership with their subordinates. The remaining one quarter behaved in a ‘fair’ way.

the entrepreneurial attitude of the manager acquiring ownership over assets lasted only as long as retirement age came.

Subordinate employees mostly did not seriously demand participation in strategic and ownership decision-making. Especially if their ownership amounted to only a few percents, to sell shares the quickest possible was much more frequently the objective. Given the rapidly shrinking real wages in those years, no wonder that employees wanted some quick supplementary income. Thus in the course of privatization, employee representatives first of all concentrated on this kind of revenue, which can be called 'a one time privatization bonus'. More stable forms of employee ownership (majority shares packet, ESOP) were created where managers could promise fair treatment and hold out the image of a company using redundancy measures only as a last resort. Subordinates saw ESOP (and other durable buy-out schemes) as a tool to preserve their workplace even though the management organising the buy-out made it clear well in time that employees were buying shares not jobs. Highly qualified employees used to being in a good labour market position also hoped that their work organisations and interest advocacy positions would remain unchanged if they managed to prevent external buy-out.

As far as motivations to become owners are concerned, for survey questions most employees (two thirds of respondents) answered that they expected that ESOP would help preserve the workplace and keep the job. Most employees said they are willing to take part in shaping the conditions directly affecting them (such as labour relations, working conditions, financial incentive systems). The authors conclude that mostly employees with higher educational attainment judge correctly the possibilities related to becoming co-owners. (Rozgonyi and Jávor, 1996)

At the national level, trade unions participated in the elaboration of the various forms of employee ownership. Local unions, however, were often surprisingly passive and limited action to declare their interest in employee buy-out but did not play any role in organising the procedure, and obediently did what the managers told them to do. In other cases, however, local trade unions actively lobbied for preferential shares as well as for ESOP buy-out.

In addition to influencing privatization decisions, unions usually had at least one of their leaders as member of the ESOP trust-organising committee. . While the trade union formally did not participate in organising and running the ESOP at any of the companies, due to personal overlaps ESOP and employee representation were tightly interconnected at most workplaces. The management often tried to separate ESOP from interest representation ('This time let us represent workers as owners rather than as employees!') but it never succeeded to perfectly achieve this objective.[7]

[7] The American practice of the heydays of trade unions - whereby the conditions of becoming owner and the exercise of rights is settled in a collective agreement between the management and the trade union - is unimaginable in Hungary.

c) The Current National Policy

On the whole, in Hungary there is no definite public policy either on the employees's financial participation or on the employee ownership. While most of the political parties (both left and right) declare their commitment to the issue, concrete economic policy decisions are still missing. It seems that the legalisation and dissemination of employee's ownership needed the impetus of privatization that mobilised and at the same time divided the whole society.

In 1998 the privatization of the competitive sector was practically over. Lobbyists have been fighting for political support and financial encouragement for ESOP 'outside privatization' ever since but without any success, including the goal to make the technique applicable in case of liquidation. Furthermore, emphasising the international trend of individual account based pension system; plans to encourage tying employee ownership to pension fund membership have gone so far unnoticed.

Early regulation focused on asset acquisition, and power and interest relations at that time did not allow to address the problems of operation. Several problems of importance were solved in 2003, through the amendment of ESOP Law. It established a limit for differences in share distribution, regulated the operation of ESOP trust and the mechanism of owners' interest representation. Another important effort of lobbyists was to amend other laws (e.g. tax laws) to make sure that the unfavourable economic environment would not undermine the operation of existing ESOP enterprises.

The latest illustration is the putting on the agenda of the privatization of out-patient health care services and organizing ESOP companies. Nevertheless, there is a great deal of uncertainty around the program, not the least because of the recent referendum on the ban of the privatization of the health care system.

In the near future other forms of financial participation may penetrate in Hungary through the human resource management practise of multinational companies. So far the Approved Employee's Benefit Program is the only financial policy instrument which supports such company initiatives. Despite its limited implementation, it already shows that a 'European Model of Financial Participation' would have a great effect on dissemination due to the overwhelming presence of multinational enterprises in Hungary.

2. Types of Schemes and their Legal Foundations

a) Privatization on Preferential Terms Schemes

The first important step towards the introduction of market economy in Hungary was the Law on Business Associations of 1988.[8] This law gave the legal basis for privatization, and large State companies were transformed into limited liability companies and joint-stock companies. However, already before the transformation, a decree of the Ministerial Council[9] allowed employee ownership by means of property notes (in Hungarian '*vagyonjegyek*') (see Boda and Neumann, 1999, p. 39). The law categorized it as security, and employees of the company could acquire it free of charge.[10] Companies could issue such property notes free of charge for employees only on the debit of the after tax profit, maximum up to 10% of the total assets of the company.[11] As there was no comprehensive regulation and plan on the process of privatization during this period, this period (between 1988 and 1990) is called 'spontaneous privatization' by the Hungarian technical literature (see Báger and Kovács, 2004, p. 101). Growing need for legal control of the privatization resulted in the establishment of the State Property Agency.[12] The first privatization program was launched by this Agency following the British privatization model (see Báger and Kovács, 2004, p. 104). The new government in principle allowed all kind of privatization techniques, under the strict control of the State Property Agency. However, the most supported was the auction privatization technique (see Boda and Neumann, 1999, p. 20). Yet, it should be mentioned that in 1992 the support of the society for privatization has washed-out as many times it was seen as the main reason for layoffs (see Boda and Neumann, 1999, p. 24). During early nineties, the most popular 'tools' of privatization for employees were privatization credit, the '*Egzisztencia*' credit and using compensation note for privatization.

The next government brought a new Law on Privatization in 1995,[13] that narrowed allowances for employees, but at the same time it offered new forms and techniques

8 Law VI of 1988 on Business Associations (repealed by Law CXLIV of 1997 on Business Associations).

9 Decree of the Ministerial Council 94 of 1988 on Property Notes. However, such property notes were issue-able only until May 15, 1993. *Ibid* Section 1 (4). Later they were transferred either to shares or companies were obliged to buy them from their owners (*see* Boda and Neumann, 1999, p. 40).

10 Section 1 (2) and 2 (1) of the Decree of the Ministerial Council 94 of 1988 on Property Notes.

11 *Ibid* Section 6 (1).

12 This Agency was established by Law VII of 1990 on State Property Agency and on the Maintenance and Utilization of the Related Property. It should be mentioned that besides legal acts, so-called 'property-political guidelines' and inside regulations of the State Property Agency had an important influence on the privatization process.

13 Law XXXIX of 1995 on Realization of Entrepreneurial Property in State Ownership. This Law gave a legal framework for privatization, however in practice the privatization was implemented through the decisions of the State Property Agency. In practice, one of the problematic issues was how to secure financial sources for preferential privatization (*e.g.,* because many times the State

(Lukács, 2004, 9.5.1.3). This law is still in force, and it enumerates preferential privatization techniques. These are the following:[14] (1) privatization on deferred terms, (2) privatization leasing,[15] (3) managerial and employee buyout,[16] (4) employee privatization on preferential terms, (5) '*Egzisztencia*' credit and (6) ESOP.[17]

Privatization on deferred terms: incentive to pay on deferred terms for the privatized (acquired) property can be granted for maximum fifteen years period.[18] The interest rate on such credit cannot be less than 50% of the all time official national bank interest rate.[19] The ownership passes to the buyer with the payment of the first instalment.[20]

Employee privatization on preferential terms. In the context of privatization on preferential terms during the privatization of State property, according to the law in force, it is possible to grant discount up to the amount of 150% of the annual minimal pay. However, the nominal value of shares acquired this way may not exceed 15% of the company's registered capital and the discount granted may not be above 50% of the purchase price. This allowance can be used either individually, or in organized form.[21] It was popular during the so-called simplified privatization to employees of small- and medium-sized enterprises (Lukács, 2004, 9.5.1.1).

'Egisztencia' credit[22] can be taken up to 50% of the property that want to be acquired, and maximum up to 50 million HUF, regardless the number of buyers.[23] The law also sets up criteria for eligibility of taking such credit:[24]

- the applicant for such credit has to qualify for domestic person under foreign exchange laws (*see* Lukács, 2004, 9.5.2.5) or legal persons with exclusively having domestic persons as members and being registered in Hungary,
- the applicant has to comply with the credit awarding requirements of credit institutions,

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Property Agency did not fulfill its obligations prescribed by the law). Another issue was that the State Property Agency was organized in a business entity form (joint-stock company) and was not part of the State administration. Thus, its decisions were not challengeable as administrative decisions.

14 Section 46 of Law XXXIX of 1995 on Realization of Entrepreneurial Property in State Ownership.

15 This technique is not discussed here because of the reasons mentioned under note 3 *supra*.

16 *See ibid*.

17 *See infra* part 2 b).

18 Section 46 (2) of Law XXXIX of 1995 on Realization of Entrepreneurial Property in State Ownership.

19 *Ibid* Section 46 (4).

20 *Ibid* Section 46 (5).

21 *Ibid* Section 55-57.

22 *See* also *infra* '*Egisztencia*' credit notes.

23 Section 58 (3) of Law XXXIX of 1995 on Realization of Entrepreneurial Property in State Ownership. This rule applies to ESOP credits as well.

24 *Ibid* Section 59 (1) (3).

- the same applicant may take within three years only once credit,
- the applicant disposes with adequate financial source for the transaction,
- the property bought on the credit may be alienated only with the consent of the credit institution until the credit is not repaid.

b) Employee Stock Ownership Plan (ESOP)

In Hungary the establishment and functioning of ESOPs is regulated by *Law XLIV of 1992 on Employee Share Ownership Program*, which entered into force on July 14, 1992.[25] The preamble of the law itself says that the aim of ESOP is the acceleration and furtherance of the privatization process.[26] The American ESOP system had a strong influence on the preparation of this law, and basically Hungarian ESOPs followed the American 'trust' model (see Luxne and Szucs 1993, p. 9; Boda and Neumann, 1999, p. 45). However, there is a major difference between the two systems: in Hungary ESOP is a privatization form with the organization ceasing to exist as soon as all the securities are paid for, and their ownership is transferred to the employees.[27] In the United States, an ESOP is an organization that administers securities of employees, and that does not cease to exist when the credits are repaid.[28] We are on the opinion that the American system should be followed at least regarding the goals of such an organization.

According to statistics, companies with ESOP organization, on average, are financially more successful than those not in partial or full employee ownership (see Lukács, 2004, 9.5.2.2). Though, studies show that the huge majority of ESOP buyouts are in practice management buyouts (see Galgóczi and Hovorka, 1998, p. 4). As far as remuneration is concerned, employees employed with companies in partial or full employee ownership earned 144% of the pay of employees of companies not in such ownership in year 2000 (see Lukács, 2004, 9.5.2.2). However, during the last few years there were no new ESOPs established, partly because this form was linked to privatization of State property, and partly because of lack of tax and other benefits related to the 'refreshment' of membership of ESOP organization.[29] Entrepreneurial prohibition pre-

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25 Amended with Law CXIX of 2003 on Amendment of Law XLIV of 1992 on Employee Share Ownership Program.

26 Preamble of Law XLIV of 1992 on Employee Share Ownership Program.

27 Section 24 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

28 For the ESOP organization that exercises ownership rights, basically the American 'trust' model was used (s*ee* Boda and Neumann 1999, p. 45; Mocsáry, 1998, p. 63). Another difference was between the American and Hungarian regulation that under the 1992 ESOP Law there were no 'fairness' rules (this led to disproportionately large manager ownership). However, this was changed with the 2003 Amendments. It should be also noted that the ESOP Law do not differentiate between employees and managers.

29 It also happened that the management used the employees to gain ESOP related benefits during the establishment of the organisation. Following the purchase of shares the management restructured the company (at the same time slicing the old company), replaced some employees to newly

scribed by the law on ESOPs was also impediment of their flexible functioning and further development (see Mocsáry, 1998, p. 69). The new amendment to the ESOP law states that: 'the organisation can pursue other economic activities only to help to achieve its goals.'[30] Though, this amendment constitutes progress compared to the old text of the law, this provision is still too vague.

Hungarian literature distinguishes between two kinds of ESOPs: so-called 'privatization' and 'non-privatization' ESOPs (see Szakértői Munkaközösség [Experts Panel], 1990, pp. 49-50). In the case of the former, the ESOP organization buys the property of the State Property Agency or that of the municipalities and there are incentives related to this form. In the case of the latter, shares or business shares that are not at the disposal of State Property Agency are sold, *e.g.,* already existing securities or securities issued in the case of capital increase (*ibid*) also foreseen by the ESOP law. However, as there are no specific incentives related to non-privatization ESOP, it does not encourage companies and employees to establish non-privatization ESOPs.

(1) Coverage and Prerequisites

There can be made distinction between privatization and non-privatization ESOPs only regarding incentives. Otherwise, the provisions of the Law XLIV of 1992 on Employee Share Ownership Program apply to both forms. ESOP organization can be established in any limited liability company or joint-stock company (except financial institutions and insurance companies) registered in Hungary.[31] Anybody can initiate the establishment of an ESOP organisation, the person even does not have to be employee of the company (see Lukács, 1993, p. 22). However, to participate in the organisation the person has to be employed by the given company at least in half of the official work time[32] and has to have existing employment relation with the company for at least six months (even a longer time, but maximum five years, can be required by the statute of the ESOP organisation).[33] According to the original ESOP law of 1992, retired employees had to secede from ESOP. This was unjust and disadvantageous for these employees, as because of long repayment period they could not have their share of the profit (see Mocsáry, 1998, p. 68). However, the 2003 amendment of the Law has changed this situation, and now the retired employee can decide if he/she wants to remain member of the ESOP.[34]

established companies that are separate legal entities, so the ESOP membership of these employees ceased. Also, there can be abuse during the distribution of securities, as this issue is allowed by the law to be regulated in an agreement made by the members of the ESOP organisation. *See* Mocsáry (1998, p. 68-70).

30 Section 16 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

31 Section 1 (1) (7) of Law XLIV of 1992 on Employee Share Ownership Program.

32 The official work time in Hungary is 40 hours per week. Section 117/B (1) of Law XXII of 1992 on Labour Code.

33 Section 1 (2) of Law XLIV of 1992 on Employee Share Ownership Program.

34 Section 1 (4) of Law XLIV of 1992 on Employee Share Ownership Program.

To establish an ESOP organization, the first prerequisite is a written declaration of at least 25% of the company's employees, in which they state that they wish to acquire securities of the company.[35] Following this, the employees of the company elect a three member organizing committee.[36] Support of the company management is not required, however, it is desirable (see Luxne and Szucs 1993, p. 9). The organising committee's duty is to negotiate with the potential seller (company) and with potential creditors (*e.g.,* banks).[37] It has also to prepare a feasibility study, in which it examines the financial situation of the company to see if the company will be able to carry the financial burden of the program.[38] This study has to be countersigned by the representative of the company.[39] Afterwards, the committee prepares the credit application and the purchase offer. If the credit institution approves the plan, the organising committee negotiates the conditions of securities' purchase with the company owner. It can prepare a draft of the purchase contract. The committee is also responsible for the preparatory legal work related to the establishment of the ESOP organisation, *e.g.,* drafting of the proposal of the statutes. Finally, it convenes the statutory meeting (members' meeting) of the future ESOP organisation.[40] At this meeting, at least 40% of employees of all the employees of the company have to agree on the establishment of the ESOP organisation and adopt the statute of the organisation.[41] At the same meeting the members elect the board of the ESOP organisation that will represent it, as with the establishment of the organisation the organising committee ceases to exist.[42]

The new representatives have the duty to register the organisation at the competent county court or at the Municipal Court of Budapest.[43] With the registration the organisation becomes legal entity, established with the purpose of acquiring shares in the business organisation where the members of the ESOP organisation are employed, with registered members and self-government.[44] Thus, it is a non-profit organisation under the supervision of the office of the public prosecutor.[45] The highest decision-

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35 *Ibid* Section 2 (1).

36 *Ibid.*

37 Section 1 (1) and 3 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

38 *Ibid* Section 2 (3).

39 *Ibid.*

40 *Ibid* Section 3 (3).

41 *Ibid* Section 4 (3).

42 *Ibid.*

43 *Ibid* Section 6 (1). Any subsequent amendment in the statute or in the data of the organization has to be reported to the court in 30 days (Section 6 (3) of Law XLIV of 1992 on Employee Share Ownership Program).

44 Section 4 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

45 *Ibid* Section 11. It may pursue only limited economic activity (*see* Galgóczi and Hovorka, 1998, p. 4).

making organ of the organisation is the members' meeting,[46] which has exclusive competence (among others) on the following issues:[47]

- laying down and amendment of the provisions of the statute,
- adoption of the annual budget,
- election, recall, remuneration of the representatives (board) of the organisation,
- adoption of the annual report of the board,
- establishment of proportion of property share of participants in the program,
- decision on the acceptance of the conditions of the credit.

Decisions of the meeting require simple majority.[48] An employee can be member of only one ESOP organisation at the same time.[49] It is possible that in one business organisation there are two ESOPs functioning (only two, because of the 40% employee support requirement). There is no provision of the law that would exclude new members (new employees or old ones that did not want to join the organisation at the time it was established) to become members of the ESOP organisation. After the ESOP has been established, it can conclude purchase agreement with the seller, and credit agreement with the credit institution. Following the conclusion of the purchase agreement, the ESOP organisation becomes owner of the securities. The ESOP organisation as legal entity takes the loan from the creditor or agrees on the terms of payment of instalments with the seller. The organisation has full liability for its obligations.[50] Members of the organisation are not liable for debts of the organisation except with the securities already allocated to them.[51]

The organisation ceases to exist:

- when the ownership of all the shares is transferred to the employees of the ESOP organisation,[52]
- if after the repayment of the credit the annual average number of ESOP members is under 25% of the total number of employees of the company, or
- if the company where the ESOP is organised ceases to exist.[53]

However, as long as all the securities are not paid for they cannot be sold or transferred to the members of the organisation.[54]

46 *Ibid* Section 7 (1).
47 *Ibid* Section 7 (2).
48 *Ibid* Section 7 (5).
49 *Ibid* Section 4 (4).
50 *Ibid* Section 13.
51 *Ibid.*
52 In this regard the English model was followed, meaning that following the payment of shares, everybody can dispose freely with his/her shares (see Boda and Neumann, 1999, p. 26).
53 *Ibid* Section 24 (1) (2) of Law XLIV of 1992 on Employee Share Ownership Program.

(2) Incentives

It should be repeatedly emphasised that any incentive is applicable only to 'privatization' ESOPs. 'ESOP' credit is available to employees on preferential terms, however, own resources of the organisation must be at least 2%.[55] The pertinent decree[56] states that preferential credit can be used among others by ESOP organizations for privatization of State property. If the securities are sold by the State Property Agency, and the Agency uses the income from the sale for the repayment of State debt, the ESOP organisation can resort to preferential credit or instalment payment plan.[57] Another requirement is that limited liability companies and joint-stock companies be in majority State ownership. The terms of the credit[58] are set as follows:

Amount of credit	**Own sources (in % of the amount of the credit)**	**Duration (years)**	**Grace period (years)***
Up to 5 million HUF	2	15	3
Above 5 million HUF	15	15	3

* During the grace period only the interest of the credit has to be paid.

(3) Taxation

There is no tax allowance or other neither for employees or the ESOP organisation nor for the company (only the above mentioned incentives for privatization ESOPs) (see Lukács, 2004, 9.5.2.5). The only exemption is, that the company where the ESOP is established (provided the employees purchased State property, that is to say, it is a 'privatization' ESOP) can resort to tax allowance for the property sold to the ESOP organisation prescribed by the Corporate Tax Law (see Lukács, 2004, 9.5.2.5). Accordingly, the company is entitled for tax base allowance up to 20% of the amount of the tax base (without this amount). Thus, amounts paid to ESOP organisation can be deducted up to 20% from the company's tax base.

ESOPs were not subject to corporate profit tax until December 31, 1996. However, following this date, the income of ESOP organisations falls under the rules of the Law on Corporate Tax and Dividend Tax, and accordingly 16% tax is paid on the tax base income of the organisation for every tax year following the tax year.[59] However, two special rules apply when calculating the tax base of ESOPs: (1) the tax base should be reduced by the amounts paid in by private persons as their own contribution to the ESOP organisation and by amounts of subsidy paid in by other private or legal per-

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54 *Ibid* Section 18 (3).

55 Section 8 (2) of Governmental Decree 28 of 1991 on '*Egzisztencia*' Credit and Deferred Payments Benefits.

56 *Ibid* Section 3 (1).

57 Section 15 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

58 Section 8 (2) of the Governmental Decree 28 of 1991 on '*Egzisztencia*' Credit and Deferred Payments Benefits.

59 Section 2 (2) (e) and 19 (1) of Law LXXXI of 1996 on Corporate Tax and Dividend Tax.

sons, or by the company employing the members of the ESOP (otherwise these amounts should have been accounted as income). (2) At the same time, the tax base has to be increased by the acquisition value of the shares given to the ownership of members of the ESOP organisation – on the pretence of transferring means without compensation, that amount is accounted among expenditures (reducing the profit) according to the rules of accounting (see Földes, 2005, p. 573).

According to Personal Income Tax Law,[60] securities transferred from the company to the employees (as part of the ESOP)[61] are tax free, such securities are not considered income.[62] However, at the time of sale of such securities by the employee, the income from this sale is considered capital gain and taxable at a rate of 20% (or 35%).[63]

(4) Link to Participation in Decision-Making

In Hungary the law does not make distinction between companies in employee (or in partial employee) ownership and those that are not in such ownership. All registered companies fall under the Law on Business Associations,[64] and there is equal treatment under the law of companies regarding the method of decision-making.[65] However, it

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60 Personal income tax in Hungary is based on a progressive scale from 18 to 38%:

Amount of income:	Tax and tax rate:
0-1,500,000 HUF	18%
From 1,500,001 HUF	270,000 HUF plus 38% of the portion above 1,500,000 HUF

(Section 30. Law CXVII of 1995 on Personal Income Tax, on Feb. 28, 2005).

61 Any individual who either has permanent residency in Hungary or whose temporary residency exceeds 183 days in a given tax year (calendar year) has an unlimited tax liability (also qualify for 'domestic person' under foreign exchange laws) under Hungarian income tax law. The amount of tax paid is based on the individual's total revenue, regardless of origin. A foreigner temporarily resident in Hungary, however, has a limited tax liability: The amount of tax paid is based only on revenue gained from work performed and other revenue obtained in Hungary (Section 2 of Law CXVII of 1995 on Personal Income Tax). Hungary is party to a Treaty for the Prevention of Double Taxation with several countries which basically follows the Organization for Economic Cooperation and Development model. These tax treaties allow taxpayers to pay reduced tax rates on income earned by submitting a duly issued 'certificate of residency' confirming the taxpayer's primary tax residence abroad. Any Double Taxation Prevention Treaty takes precedence over the Hungarian Personal Income Tax Law (Section 2 (5) of Law CXVII of 1995 on Personal Income Tax).

62 Section 18 (4) of Law XLIV of 1992 on Employee Share Ownership Program.

63 Section 66 of Law CXVII of 1995 on Personal Income Tax; Securities acquired from already taxed personal income of the participant of the program are not taxable.

64 Law CXLIV of 1997 on Business Associations.

65 The highest decision-making body of the limited liability company is the members' meeting and in case of joint-stock company is the shareholders' meeting. (*Ibid* Section 18 (1)) Quorum rules require more than half of all the shares (both for limited liability company and joint-stock company) to be represented (*Ibid* Section 236). However, the articles of incorporation may require higher rate. If there is no quorum at the first meeting, the second, repeated meeting can bring decision regarding issues that were on the agenda of the first meeting without having quorum. As a general rule, decisions are brought by majority vote (*Ibid* Section 19 (1)). In case of joint-stock company,

might be that the articles of incorporation give more rights to employee owners (*e.g.,* issuing preferential shares). In practice, usually employee shareholders or the ESOP organisation does not have any advantage or disadvantage regarding participation, but they take part in the process of decision-making proportionately to their shares (see Boda and Neumann, 1999, p. 80).

More specifically, regarding ESOP organisations as already mentioned above, the organisation is the owner of the shares. Concerning exercise of property rights, participants have voting rights in the proportion of their registered shares, but maximum up to 5% of the property acquired by the ESOP organisation.[66] However, in many issues related to decision-making in ESOP organisation the law gives a large freedom to the members of the organisation to establish 'internal' rules in this field.[67] Rights of participation that result from the ownership of shares by the ESOP organisation are exercised through the representative of the organisation, however the articles of incorporation can stipulate differently.[68]

c) Employees' Shares

Employees' shares were first introduced by the Law on Business Associations of 1988.[69] Employees' shares can be issued free of charge or at reduced price in accordance with the provisions of the articles of incorporation (statutes) of the joint-stock company.[70] They are registered shares.[71] Such shares may be issued with a simultaneous share capital increase of the joint-stock company, up to 15% of the increased share capital at the most.[72] A joint-stock company may pass a resolution on the issue of such employees' shares which entitles their holders to dividends from after-tax profits to be distributed among shareholders prior to the shares belonging to other categories or

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there are only few issues that require ¾ majority: (1) adoption and amendment of the articles of incorporation, (2) changing the form of the company, (3) winding up the company and (4) amending rights related to shares. (*Ibid* Section 237 (3))

66 Section 7 (6) of Law XLIV of 1992 on Employee Share Ownership Program.

67 Having examined the statute of a Hungarian ESOP organization, that was established at a Hungarian foreign trade company, it can be concluded, as already pointed out above, that these organizations were used more as privatization form (technique) than a participation instrument of employees in the company. The statue only mentions the right to participation of members in the decision-making in the company: 'member has the right to exercise shareholders rights through the representative of the ESOP organization.' However, the exact procedure is not regulated (nonetheless, some other procedures are regulated in detail in this document). Supposedly, decision-making is similar to other procedures, and members take part in the management of the company by the way of an elected representative. *See also* Boda and Neumann (1999, pp. 80-86).

68 Section 17 (1) of Law XLIV of 1992 on Employee Share Ownership Program.

69 Section 44 of Law VI of 1988 on Business Associations.

70 Section 187 (1) of Law CXLIV of 1997 on Business Associations.

71 *Ibid.*

72 *Ibid* Section 187 (2).

classes of shares, but following shares granting preferred dividends.[73] However, the main idea of this special type of shares is to ensure the possibility for employees to acquire cheaper shares of their company.[74]

(1) Coverage and Prerequisites

Employee shares are registered shares, and can be acquired only by full time or part time employees or group of employees of the company.[75] Employees' shares may be transferred only to the employees of the joint-stock company, or to persons whose employment relationship is terminated due to retirement.[76] In the event of death of an employee or the termination of his/her employment relationship, excluding the case of retirement, his/her heir or former employer shall have the right to transfer the employees' shares in question to other employees of the company within a period of six months.[77] If this deadline expires without success, at the first shareholders' meeting thereafter, the company shall withdraw the employees' shares in question with a corresponding reduction of its share capital, or shall decide to sell such shares after transforming such into ordinary shares, or preference or interest-bearing shares.[78] Thus, the limited transferability of this kind of shares reduces its value.

(2) Taxation and Incentives

The company issuing such shares can give up to 90% discount by the purchase of these shares, which makes this form of financial participation very attractive for employees. However, there are no tax incentives related to this form of share acquisition (see Lukács, 2004, 9.5.1.3). From January 1, 2003 income received in the form of securities is not regarded any more as allowance in nature. The applicable rules of taxation are determined by the legal relationship between the private person and the provider. In case of securities provided by employer to employee, such income is considered as income from employment, and pertinent tax rules has to be applied.[79] Thus, in case of employees' shares, the difference between the purchase price and the sale price falls under personal income tax.[80]

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73 *Ibid* Section 187 (1).

74 According to research done by the National Employment Office of Hungary, employee share ownership is insignificant in Hungary. Interview with Dr. László Neumann (Budapest, February 10, 2005).

75 *Ibid* Section 187 (1) of Law CXLIV of 1997 on Business Associations.

76 *Ibid* Section 187 (2).

77 *Ibid* Section 187 (4).

78 *Ibid.*

79 *See* Informant of the Tax and Financial Control Administration (APEH) on the Rules on Securities Allowance in Force from January 1, 2003. Source: Hungarian CD Jogtar (Feb. 28, 2005).

80 *Ibid.*

(3) Participation in Decision-Making

As already mentioned *supra* in the part dealing with ESOP organizations, the law does not make any distinction between shareholders of the same class, thus participation of employees with the ownership of employee shares is the same as any other common shareholder's.

d) Approved Employee Securities Benefit Program

From January 1, 2003 new legislation entered into force (with some provisions in force from January 1, 2004) allowing companies to set up State-recognized, tax-qualified stock plans. Relevant provisions can be found in *Law CXVII of 1995 on Personal Income Tax* and in the *Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure.* If the Ministry of Finance approves the program, it informs the competent Tax Authorities about its decision.[81] However, the deposit custodian, or in some cases the organizer of the program is under duty to supply data to the Tax Authorities within fifteen days from the date the security[82] ceases to be in deposit for the employee, or if it is transferred to new deposit custodian.[83]

(1) Coverage and Prerequisites

The business association itself initiates and organizes such a program.[84] The organizer of the employee securities benefit program has to submit an application for the recognition of the program as an approved program[85] to the Ministry of Finance.[86] To be approved, the program must meet the following conditions:[87]

- only securities issued by the applicant company or by its majority shareholder may be offered in the program,

81 Section 10 of the Decree of the Ministry of Finance No. 5 of 2003 on Procedure of Registration of Approved Employee Securities Benefit Program, and the Rate of Administration Service Fee for the Initiation of the Procedure.

82 These shares are common shares, and may be issued only by companies registered at the Stock Exchange.

83 *See* Informant of the Tax and Financial Control Administration (APEH) No. 8001 of 2003 on Supplying of Data and Reporting Duty Related to Approved Employee Securities Benefit Program.

84 Section 77/C (24) (e) of Law CXVII of 1995 on Personal Income Tax.

85 The law states that 'approved programs' are those which are registered as such with the Ministry of Finance. *See* Section 77/C (24) (a) of Law CXVII of 1995 on Personal Income Tax.

86 Section 3 of Decree of the Ministry of Finance No. 5 of 2003 on Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

87 Section 77/C (19) of Law CXVII of 1995 on Personal Income Tax.

- the program has to contain the program organizer's absolute and irrevocable commitment to fulfil the program,
- the program may offer securities only to employees and executive officers of the company,
- employee participation in the program must cover at least 10% of the average number of employees registered in the year preceding the year in which the application is submitted,
- executives cannot make up more than 25% of the total participants and they cannot be given more than 50% of the total share value.

The appointed auditor (or his/her close relatives) of the applicant business association and the issuer and supervisory board members (or their close relatives) are not permitted to obtain any securities under the program. Neither the chief executive officer of the applicant business association and the issuer nor his/her close relatives are permitted to obtain securities under the program.[88]

The application has to contain[89] data on the organizer, a detailed description of the program, a signed declaration of employees participating in the program with their data,[90] data on the deposit custodian and a declaration of the organizer. In the declaration[91] the organizer declares to fulfil the program if approved, not to sell securities to persons enumerated by the law, to have published financial reports during the previous three years[92] and not to have been under insolvency proceeding[93] during the same period. The application has to contain also a draft frame-contract between the program organizer and the deposit custodian, and a single draft contract among the program organizer, the deposit custodian and the employee.[94] The application shall be counter-

[88] *Ibid.*

[89] Annex to the Decree of the Ministry of Finance No. 5 of 2003 on Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

[90] This declaration shall contain the nominal value of the securities the employee wants to acquire and declaration that the employee is familiar with the conditions of the program.

[91] Section 5 of Decree of the Ministry of Finance No. 5 of 2003 on Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

[92] The applicant company and the issuer (or their successor) had to publish annual reports, containing the auditor's endorsement, for the last three financial years prior to the submission of the application in compliance with the legal requirements prescribed by the law of the State in which it is established.

[93] Or liquidation proceedings or equivalent proceedings under its own law. Section 77/C (19) of the Law CXVII of 1995 on Personal Income Tax.

[94] Section 77/C (2) of Law CXVII of 1995 on Personal Income Tax.

signed by an attorney at law or tax advisor.[95] The fee of the application is 500,000 HUF.[96]

(2) Taxation and Incentives

At the time of sale, the employee is subject to tax on the spread between the exercise price and the sale price. Such capital gain is taxed at 20%, separately from other income.[97] Companies have no withholding or reporting obligations in connection with employee stock option or purchase plans. The first HUF 500,000 of the shares that have met the vesting requirements are not taxable at exercise or vesting.[98] Any shares deemed non-qualified are taxed as normal employment income (see Lukács, 2004, 9.5.2.5).

(3) Link to Participation in Decision-Making

Once employees exercise the shares, the shares must be held in a security account overseen by a custodian, and there is an obligatory three years vesting period which ends on December 31 of the second year subsequent to providing securities.[99] Following this, they have the same rights as any other shareholder from the same class of shareholders.

e) Co-operatives

Following the Second World War, co-operatives came into being in Hungary by the will of the State (see Gál et al., 2002, p. 17). Following the transition, laws on co-operatives treated co-operatives practically as business associations (see Lukács, 2004, 9.5.1.1). The property of 'old' co-operatives was divided between members, ex-members and their heirs in form of registered shares.[100]

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95 *See* Annex to the Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

96 Section 12 (1) of Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Program, and on the Rate of Administration Service Fee for the Initiation of the Procedure; 1 EURO = 249 HUF. Source: Hungarian National Bank, web page visited: April 26, 2005 <www.mnb.hu>.

97 Section 67 of the Law CXVII of 1995 on Personal Income Tax. BTW, allowances in nature are taxed at 44% in Hungary (*see* note 2). However this does not fall into the category of allowances in nature.

98 Section 77/A, 77/C of the Law CXVII of 1995 on Personal Income Tax.

99 Section 77/A, 77/C of the Law CXVII of 1995 on Personal Income Tax.

100 However, following privatization these property shares in the co-operatives were not extractable in parts from co-operatives, it is possible only to sell them as shares from the co-operative.

The first law on co-operatives was enacted in 1992. Today, there are two laws on co-operatives in force, the 'old' one of 1992[101] and the 'new' one, the Law on New Co-operatives[102] that entered into force on January 1, 2001. Following this date, co-operatives can be established only in accordance with the provisions of the new Law. Co-operatives that existed prior to the above date can function in accordance with the old Law until December 31, 2006. However, they have to decide until this date whether they will keep on functioning as a co-operative (in this case they have to adjust to the provisions of the new Law), transform to other form of enterprise or cease to exist.[103]

In the following we will give only short overview of regulations on co-operatives in general, and following that concentrate only on issues that are relevant for our research. Where other is not marked, the provision relates to both old and new Law.

The old Law defines co-operative as a 'collective established in accordance with the principles of the freedom of association and self-help that pursues, through the personal participation and financial contribution of members, entrepreneurial and other activities serving the interests of members, within the framework of democratic self-government.'[104] Under the new Law it is defined as an organization founded to carry on business with predetermined (in the articles of foundation) amount of notes representing share in the co-operative ('*részjegy*'). Its functioning is based on the principle of open membership and changing capital that aims the promotion of the economic and other activities of its members.[105] Co-operatives are legal entities.[106] At least five persons (both natural and legal persons)[107] are needed to establish a co-operative. The co-operative comes into existence with registration at the court of registry.[108] The co-operative is represented by the president of the board of directors (or the chief executive officer if it is a small one) or a member of the board of directors stipulated in the

101 Law I of 1992 on Co-operatives (the 'old' law).

102 Law CXLI of 2000 on New Co-operatives.

103 *Ibid* Section 89.

104 Section 3 of Law I of 1992 on Co-operatives.

105 Section 3 (1) of Law CXLI of 2000 on New Co-operatives.

106 Section 3 of Law I of 1992 on Co-operatives; Section 3 (1) of Law CXLI of 2000 on New Co-operatives.

107 Law I of 1992 on Co-operatives does not allow that the number of legal person members be higher than that of natural persons, except if the *majority* of members are co-operatives. *Ibid* Section 4 (1). The new law is stricter when it states that the percentage of non-natural persons members may not reach 50% of the all members, except if *all* the members are co-operatives. Section 5 (2) of Law CXLI of 2000 on New Co-operatives.

108 Section 7 (2) of Law I of 1992 on Co-operatives; Section 11(3) of Law CXLI of 2000 on New Co-operatives.

articles of foundation.[109] The articles of foundation can depart from this, and stipulate differently representation.[110]

(1) Coverage and Prerequisites

The articles of foundation might prescribe a 'common interest' that might be the condition for membership,[111] however by taking new members and by defining duties and rights of members, there cannot be made any kind of discrimination.[112] There is a special body that decides on the application of new members.[113] The law also provides for the cases in which membership terminates, however the articles of foundation might prescribe other causes as well.[114] The member may subscribe to the number and amount of notes representing share in the co-operative ('*részjegy*') specified in the by-laws.[115]

According to the old Law each note representing share in the co-operative has to be issued on an identical amount. Such note is nontransferable and is not subject to court execution if the co-operative member bears liability towards a third party.[116] A share entitles a holder to receive the appropriate dividend from the after-tax profit of the co-operative.[117] Co-operative members may, apart from subscribing to notes representing share in the co-operative, make other forms of financial contributions and may give loans on interest to the co-operative.[118] Notes representing share in the co-operative are transferable and inheritable, and entitle their holders to annual dividends on the after-tax profit of the co-operative. No interest is payable on notes representing share in the co-operative.[119] Provided that a member of the co-operative wishes to transfer

[109] Section 11 (1) of Law I of 1992 on Co-operatives; Section 13 (1) of Law CXLI of 2000 on New Co-operatives. However, the new Law does not enumerate the chief executive officer.

[110] Section 17 (2) (g) of Law I of 1992 on Co-operatives; Section 13 (1) of Law CXLI of 2000 on New Co-operatives.

[111] Section 42 (3) of Law I of 1992 on Co-operatives; Section 46 (2) of Law CXLI of 2000 on New Co-operatives.

[112] Section 42 (1) of Law I of 1992 on Co-operatives. The new Law does not mention any kind of non-discrimination principle.

[113] This body is constituted by the founding members in the articles of foundation. Section 43 (1) of Law I of 1992 on Co-operatives; Section 47 (1) of Law CXLI of 2000 on New Co-operatives.

[114] These are: the member dies (or a legal person is terminated), the member resigns, the member is excluded, the co-operative transforms to company or the co-operative terminates its operations without legal successor. Section 48 (1) of Law I of 1992 on Co-operatives. The new law enumerates the same reasons, and adds one more: if the member did not fulfil his/her financial contribution. Section 60 (b) of Law CXLI of 2000 on New Co-operatives.

[115] Section 52 (1) of Law I of 1992 on Co-operatives; Section 53 (1) of Law CXLI of 2000 on New Co-operatives.

[116] Section 53 (1) of Law I of 1992 on Co-operatives.

[117] *Ibid* Section 53 (2).

[118] *Ibid* Section 54 (1).

[119] *Ibid* Section 56 (1).

his/her note representing share in the co-operative to an outsider, the co-operative and its members are entitled to the right of preemption. If those who have the right of preemption do not state their claim within 30 days of the announcement of the transfer of the equity, it is taken for granted that they do not intend to avail themselves of the right.[120] The members' meeting may decide on the purchase by the co-operative of the notes representing share in the co-operative a co-operative officer.[121] Unless the noteholder is a member of the co-operative, at the members' meeting he/she has right of say but not vote.[122] The co-operative must keep records of the holders of notes representing share in the co-operative and of the nominal values of these.[123]

The new Law does not places such emphasis on the notes representing share in the co-operative. The new Law only states that the membership and membership rights and duties are represented by notes representing rights in the co-operative.[124] The new Law also obliges the co-operative to have a register of the members and their contributions.[125] However, the Law states that irrespective of their contribution, members have the same rights in the co-operative.[126] The members' meeting decides on the dividend (on the proposal of the board of directors and the supervisory board) based on the economic cooperation with the members.[127]

(2) Decision-Making and Organs

The highest decision-making body of the co-operative is the members' meeting. It makes decision in the most important issues related to the co-operative.[128] This body

120 *Ibid* Section 56 (2).

121 *Ibid* Section 56 (3).

122 *Ibid* Section 56 (4).

123 *Ibid* Section 57 (1).

124 Section 49 (1) of Law CXLI of 2000 on New Co-operatives.

125 Section 50 of Law CXLI of 2000 on New Co-operatives.

126 Section 51 (2) of Law CXLI of 2000 on New Co-operatives.

127 Section 58 of Law CXLI of 2000 on New Co-operatives.

128 These issues are: (1) formulation and amendment of the bylaws; (2) election and relief from duties of the members and the chairman of the board of directors; (3) election of the members and chairman of the supervisory board and relieving them of their duties; the commissioning and relieving of duties of other persons seeing to their tasks; (4) setting the fees of office holders; (5) determination of the amounts of money represented by shares and the nominal value of co-operative quotas; (6) adoption of the annual report and decision-taking on the use of post-tax profits or on sources for covering losses; (7) decision-making within the framework of the bylaws on what is to happen with indivisible property; (8) decision-making on the fusion, splitting, reorganization or dissolution of the co-operative; (9) entry into co-operatives and business organizations, and quitting; foundation of a co-operative or business organization if the assets contributed exceed the value defined in the bylaws; (10) entry into an interest organization, and secession from it; (11) decision-making on the starting of court action for damages against an office holder; (12) whatever else the bylaws refer to the competence of the members' meeting. Section 20 (1) of Law I of 1992 on Co-operatives; Section 22 (1) (2) of Law CXLI of 2000 on New Co-operatives.

has to be convened at least once a year. It is convened by the board of directors.[129] Any issue might be put on the agenda on the initiative of at least 10% of all the members.[130] Concerning quorum rules, at least half of the members have to be present,[131] and if there is no contrary provision in the law or in the articles of foundation or in the decision of the members' meeting, decisions are made with 50% plus one vote of the members present at the meeting, with public voting.[132]

The board of directors (or if there are less than 50 members it might be the chief executive officer) elected by the members' meeting, manages everyday activities of the co-operative. It forms the working structure, exercises employer rights and makes decision regarding every issue that is not in the competence of other organs.[133] It is accountable and reports to the members' meeting.[134]

The co-operatives have a supervisory board that is also elected by the members' meeting.[135] Its main duty is to supervise the activities of the co-operative.[136]

(3) Taxation and Incentives

Regarding taxation of the co-operative as organization, it is subject to the Law on Corporate Tax and Dividend Tax (*see supra* part 2.VI.b.), and pays 16% tax on its realized

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129 Section 21 (1) of Law I of 1992 on Co-operatives; Section 23 (1) and 24 (1) of Law CXLI of 2000 on New Co-operatives.

130 Section 21 (3) of Law I of 1992 on Co-operatives; Section 25 (1) of Law CXLI of 2000 on New Co-operatives.

131 Section 22 (1) of Law I of 1992 on Co-operatives; Section 28 (1) of Law CXLI of 2000 on New Co-operatives.

132 Section 22 (3) of Law I of 1992 on Co-operatives; Section 29 (1) of Law CXLI of 2000 on New Co-operatives.

133 Section 29 (1) (2) of Law I of 1992 on Co-operatives; Section 40 (1) of Law CXLI of 2000 on New Co-operatives.

134 Section 29 (3) of Law I of 1992 on Co-operatives; Section 41 (1)of Law CXLI of 2000 on New Co-operatives.

135 Section 30 (1) of Law I of 1992 on Co-operatives; Section 42 (1) of Law CXLI of 2000 on New Co-operatives.

136 Section 31 (1) of Law I of 1992 on Co-operatives. However, it has concretely defined rights by the law: (1) may examine any matter or affair connected with the operation of the organs and the management of the co-operative; (2) may instruct the board of directors to proceed in accordance with the bylaws; (3) may propose the relief or impeachment of the entire board of directors or of some of its members and also the convocation of the members' meeting; (4) may itself convoke the members' meeting if the board of directors fails to fulfil its obligation to this end; (5) on the basis of the annual report, expresses its views to the members' meeting on the management and operation of the co-operative; without this procedure no valid decision may be passed in regard to the annual report; (6) may express its opinions also on other reports and papers submitted to the members' meeting; (7) makes proposals to the members' meeting on the fees of the officers of the co-operative; (8) reports at least once a year on its activity to the members' meeting. Section 31 (2) of Law I of 1992 on Co-operatives; Section 43 (1) of Law CXLI of 2000 on New Co-operatives.

profit.[137] According to the provisions of the Law on Personal Income Tax notes representing share in the co-operative are considered securities and any income related to them is taxed accordingly.[138]

f) Profit-Sharing

Profit sharing[139] is a form of extra-wage (salary) monetary benefit that encourages employees to increase the profit of the company. It became popular in Hungary at the second part of the 1980s (see Bódis, 2005). It became practice at smaller, single owner companies. Usually, the managers get a share of the profit at the end of the business year, provided the company achieved a certain, in advance determined profit.[140] In principle, profit-sharing as part of the payment system is internal affair of companies, and the State can influence it only through tax and contribution regulations. However, as already mentioned above, there are no taxation incentives related to profit-sharing and therefore it is not popular.

3. Incidence Now and Over Time

a) Types of Employee Ownership

With the introduction of the institutions of market economy beginning in 1988 and with the proliferation of privately owned firms the models of financial participation 'usual' in market economies and various forms of share giveaway programs got green light too. Under the 'irregular' conditions of privatization, however, the various forms of participation supported centrally through preferential financial schemes (employee shares, ESOP) spread much greater. However, all forms of majority employees ownership decreased after privatization[141]

In the analysis of the legal framework it is important to highlight that in the course of privatization these forms were used in combination within one company. In Hungary three functionally different types of employee ownership were created right at the beginning: the first involved the acquisition of the minority stock packet and small owners are paid dividends. The other two forms ensured participation rights in decision-making. In the first one group of employees were made owners in one step, who later

137 Section 2 (2) (b) of Law LXXXI of 1996 on Corporate Tax and Dividend Tax.

138 Section 34 of Law CXVII of 1995 on Personal Income Tax.

139 In Hungarian '*nyereségrészesedés*.'

140 *See* Hogyan targyaljunk a fizetesrol? [How to negotiate on salary?], P & Bert Consulting, web page visited: January 24, 2005 <http://www.pbert.hu/munkav/14.html>.

141 Janky (1999) concluded to the similar result. A panel survey made between 1992 and 2000 analyses data of about 400 industrial production companies.

could become individual owners while in the second type the current employees of the enterprise are the owners.

(1) Privatization on Preferential Terms by Employees

Between 1990 and 1992 employee ownership on preferential terms was created at 540 companies in compliance with the Asset Policy Guidelines and privatization laws, typically at a level less than 10% (and nowhere not more than 15%) of employee ownership share[142]. Unfortunately, there is no available statistics on assets acquired by the management and subordinate employees through preferential purchase, still it is quite certain that in the later phase of privatization employees in almost all enterprises were offered preferential terms of buying.[143].

In the context of above-mentioned circumstances, minority ownership practically disappeared over the time. It could be translated into a durable form of ownership only in cases of buy-out companies. Such early share purchases were financed not only by preferential term, but also by bank loans and company savings too.

According to expert estimates, between late 1989 and June 1992, i.e. prior to the passing of the ESOP bill, employee and management buy-outs took place in about 30 firms (Karsai, 1993). Case studies on the early purchases suggest that managers and employees of low capital small enterprises bought their firms. Furthermore, these firms were highly specialised, employing highly qualified labour. At these companies special expertise constituted the main asset, including the network of contacts and relationships indispensable for marketing knowledge. In these cases employees were in a very good bargaining position to successfully pursue privatization plans as their special skills and knowledge could have been marketed outside the company as well. Firms of early management and employee buy-outs operate mostly in the areas of trade, designing, consultancy and research.

(2) ESOP

ESOP is a complex technique, including credit, tax and organizational provisions. It is aimed to help employees to buy the whole or a part of the shares of their companies. According to State Privatization Company (ÁPV Rt.) records, between 1992 and 1999 287 ESOP purchases took place in the nominal value of about HUF 51 billion. At the time of privatization about 80,000 worked at the 247 enterprises involved in these transactions. In addition to transactions by the State Property Agency and Privatization Company, state-owned enterprise centres operating as holdings could sell part of their assets in ESOP schemes. This latter fact explains why a total of 289 ESOP companies

142 Magyar Hírlap, 13 August 1992.

143 In course of the privatization as a whole, the 15%-pieces of assets of the various enterprises amounted to a significant total value. To give a sense of the order of magnitude, right after privatization there were altogether HUF 13.9 billion worth of employee shares in the 9 privatized electricity companies (ÁPV Rt. Annual Report 1996).

were recorded in late 1995 by Rész-Vétel Foundation, which used tax authority data. The heyday of ESOP was 1993 and 1994 with the most transactions taking place that time after a slow start; then an amendment of the law in 1995 put an end to the preferential purchase of majority ownership.

Over these two or three years, the average share of assets bought by ESOP organisations gradually decreased: while in 1993 80% of buy-outs were majority buy-outs only 66% belonged to this category in September 1994 and 48% at the end of 1995. On the whole, in 47% of cases recorded by Rész-Vétel Foundation ESOP was a full or majority owner, and in 24% an owner with controlling rights (25 to 50%).[144]

At the beginning, ESOP was a privatization technique typically used in medium and small sized companies. Nearly two thirds (65%) of the businesses involved were medium-sized companies employing 100 to 1000 and hardly more than half of the companies had as much own capital as HUF 100 to 500 million and as few as 5% of them had an over HUF 1 billion worth of capital. The greater capital a company had, it seems, the smaller was the share of ownership bought out by the employees[145].

Almost half of ESOP companies were manufacturers, one quarter were in trade and 16% in services. It is in the trading industry where the share of ESOP companies is the greatest (6%), and their share is relatively large in manufacturing and in constructions. At the same time, however, in agriculture, tourism and real estate the share of employee-owned companies is far below the average.

In summary it can be said that in 1998, the year of closing privatization, as little as one per cent of assets of companies other than financial institutions was in management or employee ownership in Hungary. Furthermore, ESOP company employees make up as little as 1,2% of employment by legal entity economic organisations (limited liability companies, joint-stock companies) (Laky et al., 1999). Of course, considering only privatized assets, the share of management and employee ownership was higher, especially at around late 1993 when it amounted to 12%[146].

After privatization was over, between 1993 and 1995, the ownership structure did not much change at the majority of ESOP companies bought from loans as debtors could not sell their shares before full repayment of the loan. As of 1996 and 1997, however, both inside ownership and the ownership share of subordinate employees considerably shrank. According to HCSO data, in the first quarter of 2005 there were 151 ESOP organisations. (While records are not fully up to date because of delays in reporting, the rate of decrease is apparent: after mass privatization was over there were about 300 ESOP organisations in 1998 and 252 in the first quarter of 2001[147].)

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144 Rész-Vétel Foundation, Summary of ownership purchase by ESOP organizations 1995.

145 *Ibid.*

146 In Mihályi's (1988) calculations, in 1993 assets sold by ESOP technique as per the contract price made up 16% of the total annual privatization revenue, and 32.0% of domestic sales.

147 Preliminary information. The number of business organisations. HCSO (2001).

Between 1995 and 1999 the share of large ESOP companies employing over 1000 dropped to half. In 1999 the majority of ESOP companies (55%) were in manufacturing but their share in trade and services shrank to 20% and 10%, respectively (Boda and Neumann, 1999).[148]

The share of companies in majority ESOP ownership decreased from the initial 58 % to 38 % by September 2000, and that of companies with 25 to 50 % ownership share ensuring the right of control decreased from 29 to 2 % in the respective period (Boda and Neumann, 2002).[149]

As a result of legal regulations, the overwhelming majority of ESOP organizations ceased to exist after the loans were repaid. Should the ESOP organisation remain, employees themselves are required to develop the regulation (such as rules of marketing shares) for the period after repayment. Furthermore, the established forms of operating the asset (such as setting up a limited company) involve considerable costs. So far only one or two companies are known to have developed the mechanisms and rules at significant expenses (both human and financial) to ensure that the ownership share is retained by the current employees.

By September 2000 around one third of companies repaid their loans. In over half of them employees remained the owners of their company, but when the ESOP organization ceased to exist, employee ownership was converted into individual small ownership and employees disposed of their shares freely and individually. Thus, these companies are not different from those in which employees are individual owners[150]. Loan repayment accelerated the shrinking of employee ownership: there are external owners in about half of unencumbered companies, which is the sign of post-privatization sale.[151]

(3) Employees' Shares

The history of employee shares in Hungary began with the distribution of property notes: state enterprises could give their employees property notes as a piece of enterprise profits. After the commercialisation of the enterprise these notes were converted

148 Balance sheet figures of ESOP companies between 1993 and 1996 were compiled by János Hovorka at Rész-Vétel Foundation using data of the of Gazdaságkutató RT (Economic Research Company). Furthermore, data of the Short Term Labour Market Forecast survey by OMMK were used to compare the financial perspectives of 121 ESOP companies and 3,512 companies in other forms of ownership, weighed by size and industry.

149 In a telephone survey in September 2000 67 ESOP companies were selected to be asked about loan amortisation, the position of the ESOP organisation, inside and external ownership and the finances of the company. 4% of the companies could not be found and 4% refused to answer (Boda and Neumann, 2002).

150 The two kinds of employee ownerships became even more similar with the amendment of the ESOP law in 2003, which allowed retiring employees to keep part of their ownership.

151 Research findings suggest that the occurrence of post-privatization sale is not greater in ESOP buyers than in other domestic buyers (Árva and Diczházi, 1998).

in employee shares and thus could be used in the buy-out. Up to 1991 the commercialisation of almost all profitable enterprises were preceded by giving out property notes.

Issuing (and quoting) employee shares is a concomitant of privatization. Originally the relevant law allowed existing enterprises with a positive balance sheet from the last year to issue free or preferential employee shares in the value of up to 10% of their raised registered capital. Many state enterprises, however, cooked their books and created a special fund called 'assets in addition to registered capital' financing employees' share purchase. While the State Property Agency basically did not support the issuance of shares free of charge against the company's own resources, this was an option in case of external buyers because 20% of the sales price was reimbursed to the company to cover employee shares.

According to a study by Teréz Laky in 1992, up to mid-1991 the State Property Agency issued permission for 20 companies to issue free shares. Preferential shares ranged from 1.15% to 16.3% of the company's registered capital (preferential shares were sold free or for 10 or 50 or 60 % of their nominal value.) Most commonly, employees could buy at 50%, payable by instalments. Company regulation on the purchase of preferential employee shares usually favoured managers as the limit was specified as a percentage of base wages. The author argues that minority packets in the form of employee shares do not ensure meaningful participation in the company's decision-making mechanism[152].

There are no statistics on the sales of employee shares and only case studies provide information on what happened to them. While employee shares might amount to 10% of the total value of privatized enterprises these forms of ownership were far from being stable as owners sold the soonest possible. The intention of employees to sell quickly was especially obvious in companies of which the share became quoted, or were expected to be, at the exchange market, and their value rapidly grew to several times as high as when on initial public offering (for instance: EGIS, MATÁV, MOL etc.) Actually, there were cases, when trade unions supported the management to resale preferential employee shares so actively that they looked for brokerage firms themselves [153].

152 Data of the State Property Agency analysed by Teréz Laky (1992).

153 For instance, in the electricity industry the trade union concluded a deal with the privatization minister prior to privatization on a special scheme of employees' ownership with bettered preferential conditions. Once foreign owners appeared in the industry the companies bought employee shares, mostly at the price the State Property Agency sold shares. As investors were granted practically unlimited management rights even with minority capital share, buying employee shares by the companies was considered an act of generosity.

Keeping their shares and influencing decision-making was never a consideration for employees. Employee shares in the course of the privatization of EGIS is a typical illustration: the trade union and the enterprise made a deal beforehand that the company will buy the shares from the employees and thereby would spare the costs of issuance and using a broker firm (Magyar Hírlap, 2 May 1998).

(4) Stock Long-Term Incentive Plans

In case of public issuance of shares, employees had some pre-emptive or reduced price purchase possibilities right from the beginning of the privatization period. In the early period of 'spontaneous privatization', at companies about to be transformed into a non-public joint-stock company and promising outstandingly great profits, managers were in the position to know important information before other buyers.[154] (Selling on the stock exchange market became significant in the last years of privatization: its share was 71% in 1997, 80% in 1998 and 98% in 1999 (László, 2004).

Our review of current company practices on long term incentives are based on data from two of the biggest consulting firms in Hungary.[155]

According to information of Hewitt Inside Ltd, in 2004 26% of enterprises used a sort of long term incentive system. Most of them (80%) launched Stock Option Plans, and many (30%) used performance shares.

In the practice of HayGroup Ltd , 37% of clients gave their employees shares in 2004.The majority (66.5%) of enterprises using employee share benefits offers employees Stock Option Plans; fairly wide spread is the share purchase program (33.4%). Stock Option Plans most often (62%) involve buying equity shares at the stock exchange, and 30% provide shares through issuing equity shares after commercialisation. Stock Option Plans last minimally for 1 to 3 years and maximum for 5 to 6 years, and the option ensures on average a 30% supplement to the employee's basic wage. The actual levels are determined on the basis of job and position, and in 67% of cases companies used some kind of performance criteria.

90% of Hungarian companies giving employees shares have adopted the remuneration policy of their foreign mother company considering the practice of long term incentives and have taken over the various forms of share benefits in their incentive policy. In these forms of financial participation, however, mostly managers were favoured as the fundamental aim of long term incentives is to make top managers identify them-

[154] A sort of legislative support for this technique is that the personal income tax of that time ensured much more favourable relief on investments than the current one. This relief, of course, were available for other forms of management and employee ownership too.

[155] The incentive system of 50 companies was surveyed by the Hewitt Associates in 2003, the majority of which were large ones in terms of sales and number of employees. The majority (66%) were foreign-owned, 20% were producing, 27% were service providers and 27% were trading companies. In their system, the contingent wage includes short and long term incentives and social and other benefits (Hewitt Inside Consulting: Total Compensation Measurement (TCM), Hungary 2004).

A similar study by HayGroup analyses wage data of 201 mostly foreign-owned companies (82%). 84% of all companies give their employees some kind of contingent wage made up of bonuses/premia, profit share, and turnover bonus in sales jobs (Hay income level study 2004, Hay Group 2005, Hay Executive Compensation Report, Hay Group 2005).

selves with the long term goals of the company, retain the key top managers at the given firm and supplement employees' income – said the interviewees[156].

(5) Approved Employee Securities Benefit Program

Security benefits programs enjoying tax relief are available as of 1st January 2003, but are too new to have any meaningful information on how they work at companies.

The new section 77 of the Act on Personal Income Tax set up the legal frames of two different schemes. Sections 77/A and 77/B is applicable for top managers of foreign-owned companies when they are given shares of the mother company. These are not employee shares in the strict sense of the word as the managers are employed by the Hungarian subsidiary and not by the mother company. The law favours this 'triangle' situation: while a personal income tax is payable because the shares are regarded as labour income, no social security contribution must be paid (earlier share benefits were regarded as in-kind benefits, belonging to the highest, 44%, income tax bracket, and also social security contribution was payable. The current regulation is more favourable, and no authority permission is required either.) In practice, however, just to be safe, companies using this kind of scheme apply for a 'Contingent tax levy order' at the Ministry of Finance in advance because the amount of money involved is quite big and in case a tax authority investigation finds non-compliance fines can be very high. This piece of law thus regulates the benefits for top managers of Hungarian subsidiaries of multinational companies, and at least partially 'whitens' of earlier tax evading practices.

More important for this paper is the use of Section 77/C regulating the broad based employee share benefits worth a relatively small amount. Because of the statutory threshold levels (at least 10% of the employees must participate; the management's share must be less than 25%; annually HUF 500 thousand worth of shares are tax fee; and respite period of three taxation years is granted before cashing), it is worth applying the scheme only in case of broad-based benefit programs. Furthermore, the permission procedure is very complicated, a broker company must be used and transaction costs are high. In the two years since the legislation as few as 7 or 8 companies have applied and have been granted permission, and the number of participating employees is not more than a few thousand. The companies typically are relatively large multinational enterprises in Hungary that adapt the share benefit programs designed by the headquarters for all of the subsidiaries. Similarly to the procedure made possible by Section 77/A and B, both adaptation of benefit schemes and application for permission is carried out by consultant or law firms hired by the enterprises. Usually they are permanent clients and the firms are familiar with both the practices of the multinational company abroad and the operation circumstances, incentive and wage systems in Hungary. The permission procedure itself is 'client friendly' in the sense that the appli-

[156] There are no available data on employees participating in company programs. The low penetration of participation, however, is seen in the HCSO labour force survey data. Less than 1%, only 281 of 30,000 respondent employees received employee shares. Unpublished data (HCSO, 2004).

cation is submitted only after it has been previously reviewed by the authority and corrections have been made, thus so far none of the applications have been refused. The Ministry of Finance, however, checks only formal requirements and has no information on the underlying economic and incentive logic. What is clear, however, from the applications submitted by companies is that the typical scheme is free share programs. An exception is the pioneering 'two for the price of one' practice of Henkel. According to the staff of the Ministry of Finance, the amount of the benefit depends on position in the hierarchy rather than on performance indicators.

In the ministry's evaluation, the main motivation for using the scheme is low taxes, which is available also with other in-kind benefits (for instance support of voluntary insurance payment, tax free up to the amount of the minimum wage – currently HUF 57,000 per month – and can be immediately used for health care services).

(6) Co-operatives

After the change of the regime the legal regulation of co-operatives changed too, breaking with the traditional co-operative spirit. Surviving and restructured co-operatives, however, play an insignificant role in economy and in employment as well. According to HCSO data, 31st December 2004 out of the 416 thousand active incorporated enterprises there were 5,219 co-operatives in operation in the country but 2,607 of them employed none and operated purely as an organisation of owners. (A typical solution in consumer co-operatives is that the real economic activities were transferred into a business organisation and thus control by membership became only a formality.) 36% of existing co-operatives work in services, 30% in agriculture and 19% in trade.[157] Employment by the co-operative sector currently is insignificant: according to data by the HCSO Labour Force Survey, in 2004 only 0.2% of the employed were income earning co-operative members.[158]

b) Profit-Sharing

In the traditional Hungarian state socialism system, profit-sharing was a flexible element of income compared to the base wage and most domestically owned companies still use this practice. Multinational- or foreign-owned companies, however, pursue their own methods developed inside the mammoth company. Some foreign- companies in Hungary apply the American incentive model which is highly profit-oriented and focuses on incentives for the management (thereby creates huge differences within the company) while others use the European model of incentives which creates smaller differences and serves longer term interests.

According to Hewitt Associates, about 80% of the enterprises in Hungary use short term incentive tools that go beyond the simple sales premium. 20% of them use profit-

157 A gazdasági szervezetek száma [Number active undertakings] (2004), Budapest: HCSO.

158 Főbb munkaügyi folyamatok [Labour report)] January–December 2004 (2005), Budapest: HCSO.

sharing. In most cases (at 67% of companies) the basis of entitlement is one's position in the hierarchy, but many places (23% of the enterprises) set other criteria as well. According to the survey, however, only 10% of entitled employees receive a share of the profits. A more frequent form of short term incentives is performance bonus, which is more democratic in the sense that it is payable to all employees at half of the companies. Also, a variety of bonuses paid on the basis of some kind of indicator other than profits are more frequent than profit-sharing.

4. Empirical Evidence of Economic and Social Effects

There is little empirical experience with the use of centrally not supported forms of participation because companies consider it their own affair. The use of the new 'Approved Employee Securities Benefit Program' is only about to penetrate. Thus, information is mostly available on the working of ESOP companies.

a) Empirical Evidence of Social Effects

(1) The Relative Weight of Employee Ownership within the Company (Ownership Share Concentration)

On average, in early time (between 1989 and 1992) buy-out transactions 85% of the employees became owners of their companies (Karsai, 1993).[159] The number of ESOP company employees was nearly 80,000 and on average 70% of employees were owners (Kubik and Matolay, 1998). [160]

The most interesting aspect of the division of assets between 'inside' buyers is the proportion of ownership of the management and of employees. The early buy-outs through limited companies created majority management ownership: in two thirds of companies the share of management ownership was 50% + 1 share and in one third 30 to 40 % (Karsai, 1993). The high share of management (CEO and managers together) ownership is underlined by data given by Kovách and Csite (1999) too: in almost half (48.9%) of the companies dominated by employee and management ownership, the share of management ownership is 50 to 99 %. [161]

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159 Surprisingly enough, the high participation rate of employees (50 to 70 %) is independent of the fact that the cash collateral for the loan came from individual payments or company assets.

160 Participation was limited only by rules that were set by the employees themselves (for instance minimum service period). Where no individual payment was needed because costs of buying were taken over by the company, almost all employees became owners, as in the majority of ESOP cases.

161 In a research in 1997, the chief executive officers of 566 large companies (with revenues over HUF 200 million) were asked about their careers and the business results of the company. The analysis compared the performance of companies of various ownership forms. (By their definition in 'em-

Generally, the management could easily obtain the desired share of ownership within ESOP organizations, too. [162] The rates of individual payments in buy-outs were based on wages and position held in the organisation almost everywhere even if payments eventually were made from company resources. Furthermore, the majority of by-laws provide that loan repayment is annually converted into individual small shares in proportion with the original individual payment, fully and automatically. [163] Few ESOP by-laws provide that shares should be converted into small ownership on an on-going basis in the course of the maturity period based on the performances and merits in the given year. Yet, this could be the way to ensure that the company remain in the hands of current employees at least during the repayment period.

In this way, what was said to be 'almost all are owners', in reality became entrenched gaps within the company right at the outset. The finding of our 1993 research was that the greatest and smallest ratios of income and ownership in a typical light industry company were 1:20 and 1:100, respectively (Boda and Neumann, 1999). In addition to CEO dominance, it was observed that of subordinate employees only the workers' elite, i.e. highly qualified skilled workers with long service period at the company, participated in the buy-out.[164]

After loans are repaid, subordinate employees becoming 'free' owners mostly sell their shares to managers. The concentration of shares sooner or later leads to majority management ownership even at companies in which this was not the original case. At companies where the number of members of the body of owners has dropped to fewer than 10, obviously the management, or to put it more accurately top managers are the dominant entrepreneur-owners. The earlier mentioned telephone survey suggests that

ployee- and management-owned companies' at least 50% of the shares of the company – or the biggest packet of stocks – were in the hands of employees, managers and the CEO. Another category, the 'entrepreneurial ownership' comprises enterprises in which the dominant owner is the CEO.)

162 The 1992 ESOP law delegates it unrestrictedly to the competence of the by-law or assembly to regulate the distribution of repaid shares between the participants. The provisions in the 2003 amendment, which limit ownership differences came far too late and could prevent extreme differences only in ESOPs set up later.

163 The management could succeed in the most company without any open conflict. Some of the case studies, however, told about tougher intervention. Some of the case studies, however, told about tougher intervention. In smaller ESOP companies and in 'buy-out limited companies', where ownership depends on the actual individual payments, managers controlled the process of quotation as well. When there was an over-demand for the originally planned ESOP asset, buyers were 'dissuaded', or executives could decide what share they wanted to buy to ensure majority control by knowing others' quotes.

164 At four enterprises covered by an early privatization research, 63.4% of 202 owner-employees had worked at the company for more than ten years and 91% had at least a vocational training (Rozgonyi and Jávor, 1996).

this became the situation in all companies where the total number of employees dropped to under 20 or 30.[165]

According to the ESOP law, the by-law regulates eligibility criteria for joining the ESOP organization at a later time. At most of the companies, financial support for down payments was a one-time act limited to privatization and late-comers are required to pay. There is hardly any by-law that provides that shares remaining in the organisation's ownership should be used as a fund to finance newcomers' preferential or free of charge purchase. These rules tend to lead in the most cases to the creation of 'exclusive' ESOP organizations.

(2) ESOP Interest Representation

The ESOP law grants full autonomy for ESOP organisations to create their own rules. In practice, however, the by-laws of ESOP organizations mostly apply the model of businesses rather than of co-operatives, consequently decision-making is based on voting according to individual payments and the ratio of shares, and only rarely on a 'one member - one vote' basis. It is a typical mistake of ESOP rules that they do not address the problem of creating transparent and democratic procedures to specify the guidelines of representation for ESOP trusts.

ESOPs have failed to find an institutional way to cope with the basic contradiction of owners' representation, i.e. employees are subordinated to the CEO but at the same time, as owners, are the employers of the CEO. The business organisation and the owners' organisation are almost never separated. At most places the chief executive officer or his/her deputy or other confidant is an important member in the ESOP organisation, too.

Our case studies suggest that top managers are rarely seriously controlled by owners (Boda and Neumann, 1999). There have been scarcely any cases when the owners' organisation fired a bad management. At most companies owners were unable to prevent the management's from pursuing plans of restructuring and redundancy even if they wanted to.[166]

According to Rozgonyi and Jávor (1996), even if strategic issues are put on the assembly agenda, employees seem to be much less interested than in issues directly affecting

[165] The research found enterprises at which the number of owner employees decreased much more than the number of all employees. Up to 2003 dividing the company up into business organisations was a legal tool to push employee owners out. Employees 'out sourced' from the main company could not keep their ownership shares as only those could participate in ESOP who were in the employment of the enterprise.

[166] Authoritarian CEOs, now in the position of owners, are of course inclined to pursue old practices. Thus, owners' fora are very much like the old workers' assembly, where opinions were heard and discussed without exercising any real influence. Often participants are not clear about their rights or prefer not to confront the management such as voting against management proposals.

them (e.g. work conditions) or in decisions on redundancy, work organisation or work order that have negative consequences.

Still, however incidental and weak this form of participation is, it has often lead to a different quality of boss-subordinate relationships. The management is required at least as much as to periodically account of their activities and convince the employee co-owners of the reasonability of managerial actions. 'Insider' ownership, however, makes it easy to maintain earlier power relations based on informal deals. In case of this form of ownership, the workers' elite can reasonably hope that they will be able to retain their privileges and have a greater chance to keep their jobs and positions in wage bargaining than other employees.

It can reasonably be concluded that the weakness of the owners' organisation has contributed to the current insignificance of this form of ownership. While in operation, ESOPs had failed to prove their usefulness and thus members could hardly wait to dispose of their shares. Even if employees keep their shares, coordinating the interests of the many small owners without the organisational and institutional frames is more difficult than before.

b) Empirical Evidence of Economic Effects

The analysis of the balance sheet figures suggests that the performance of ESOP companies between 1993 and 1997 was not worse than the average of double-entry book keeping companies (Boda and Neumann, 1999). ESOP companies in trade as well as in industrial and retail servicing were especially competitive. According to 2000 data, the share of profit making ESOP companies dropped to 70% (from 80% in 1997, based on balance sheet figures), 10% of them operated at a loss and about 20% were just about at a break-even level (Boda and Neumann, 2002). Nevertheless, cessation of ESOPs is only rarely related to business performance.[167]

Kovách and Csite (1999) found that enterprises in employees' ownership (owned by entrepreneurs and by employees and management) were more efficient than other ownership forms in terms of per assets sales revenues in 1996 and realised considerable revenues even with little company assets. At the same time, in terms of labour efficiency these companies were less successful than others: despite large lay-offs, per employee revenues were smaller than the average.

[167] There are few examples that by reselling, employee-owners tried to save their companies which in a dire capital situation had operated with a loss for 3 or 4 years. (Such cases were found mostly in the successor companies of AGROKER, a trading company of agricultural machines and tools). In other cases, mostly in food trading and construction firms, it was found that the buy-out by several domestic companies jointly was to block foreign competition. In the majority of the cases, however, the external buyers were foreign trade investors, competitors already settled in the country. Firms with a great domestic market share or valuable real estates were especially on demand. In most of them, the buy-out took place before loan repayment was over. These cases, for instance the Nagykanizsa brewery, Centrum stores and more recently MMG Automatics, were extensively covered in the media.

Janky has similar statements: chances for meaningful participatory forms are greater if the relative capital need of the company (per capital assets) and the number of employees are low. 100% employee ownership is created in enterprises where the activities are highly complex (high rate of non-series products); also, there is a significant correlation between skill-intensive production and high share of employee ownership (Janky, 2002).

In summary, those employee-owned companies operate the most successfully which were privatized early (in 1992 and 1993). Furthermore, those with minority employee owners do better than ones in majority employee ownership. Based on an analysis of changes in revenues, efficiency and liabilities since 1990, the financial management of the majority of small and medium sized MBO and ESOP companies seem to be solid and efficient. Large enterprises were the worst performing ones. Failures were due to great debts, incurred independently of privatization, and probably to bad market positions and bad management.

Employee-owned enterprises can be competitive in those segments of the market that meet special demand. The overwhelming majority of well-working ESOP companies produce for a stable domestic (or regional) market. In some of them this is a natural consequence of the type of activities they do (for instance, service providers for households). In the sectors where foreign competitors are present, ESOP companies have a chance to stay in the market by offering low prices or meeting special demand (for instance extraordinary consumer taste). Furthermore, they are at an advantage in labour intensive activities.

(1) Employment

As for human resources management, no ESOP company was found to have gone bankrupt because of employment or wage decisions made in favour of the employees. In fact, redundancy was more frequent in ESOP companies than in other enterprises. For instance, in 1999 in the first six months the number of employees decreased or remained at the previous level in over two thirds (78%) of ESOP companies while in only 60% of other kinds of enterprises (Boda and Neumann, 2002). Similar are the trends in companies of other forms of employee ownership: redundancies were the greatest in employee-management-owned companies between 1993 and 1996 (Kovách and Csite, 2002).

ESOP companies do not raise concerns in terms of wage outflow either. The projected growth index of average earnings in 1999/1998 was almost identical in the two categories of companies (Boda and Neumann, 2002).[168] Case studies suggest that in-kind benefits and cash received in connection with ownership make up an increasingly large part of remuneration of employees (Boda, 1996).

[168] The wage growth index was lower than 10% in 47% of ESOP companies, 11-15% in 38% of them, and higher than that in 15%. In 46% of the other group of companies wages did not change or by less than 10%; in 42% the growth was 11-15 %, and in 12% over 16%.

(2) Asset Management

Data suggest that the financial situation of surveyed ESOP companies worsened. While between 1993 and 1997 their debt (liabilities/own capital) and liquidity (current assets/short term liabilities) indicators were better than the average of double-entry book keeping companies, in 1998 and 1999 figures of overdue receivables were worse. In September 2000 one third of companies finished loan repayment and only one company was still in a grace period. Apart from losing companies, these companies amortized the loans on time; moreover paying the instalments seemed to be more important for them than making social security payments or paying taxes. At the same time, some reservations about employee ownership proved to be right: ESOP companies invested less in machines and real estate development than others: in the second six months of 1999 22% of employee-owned companies made some kind of investment as opposed to 38% of other enterprises (Boda and Neumann, 2002).

5. Conclusions

In Hungary employee ownership has been the most frequent form of employee financial participation. Although legislation is in place for both profit-sharing and employee share ownership, Employee Share Ownership Programme is still the prevailing form in Hungary.

The different schemes mentioned in the PEPPER reports emerged in the context of privatization as well as in the context of companies' incentive plans, though the latter to a very limited extent. Profit sharing is not widespread, while specific incentives do not exist, neither for employees nor for employers. Employee shares, including stock options, are regulated by the law, and recently the 'Approved Employee Securities Benefit Program' has been introduced, including specific incentives. Companies issuing Employee Shares can offer buyers up to 90% discount, but this special shares' value is largely reduced by their limited transferability. At the same time traditional forms like co-operatives however, play an insignificant role in economy and in employment as well.

The employee share ownership programs (ESOPs) emerging in the context of the privatization became very popular and it was regulated in detail, providing various incentives. (There were three other than ESOP financial techniques for acquiring employee ownership at preferential terms in the context of privatization: price reduction, purchase on instalment payment and purchase on credit.) Employee-ownership was mostly a societal, justice and equity policy priority thus it could only become a realistic option when privatization demand shrank and/or the popularity of privatization seemed intolerably low.

The privatization rule that – as a result of company power relations – no enterprise could be sold against the will of the local management was maintained throughout the whole privatization period. So the Hungarian ESOP spread quickly in the early phase of privatization. Despite this fact in the end the relative weight of this ownership form in the whole of the economy is not significant. With privatization over, the number of ESOP companies has been decreasing relatively fast. Set-back of this ownership form has been connected to the unfavourable regulation at least to the same extent as the economic performance of companies.

Since the end of privatization in 1998 lobbyists have been fighting without any success for political support and financial encouragement for ESOP 'outside privatization' as well as to make the technique applicable in case of liquidation. Furthermore, emphasising the international trend of individual account based pension system; plans to encourage tying employee ownership to pension fund membership have gone so far unnoticed. On the whole, in Hungary there is no policy on employee ownership. While most of the political parties (both on the left and the right) declare their commitment to the issue, concrete economic policy decisions are still missing. It seems that what has been achieved in terms of employee participation needed the élan of privatization that mobilised and divided the whole society.

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