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

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by
Jens Lowitzsch

with introductory chapters by
Iraj Hashi
Herwig Roggemann
Milica Uvalić
Daniel Vaughan-Whitehead

and a CD-ROM containing Extended Country Reports

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Author: Jens Lowitzsch
With introductory chapters by: Iraj Hashi, Herwig Roggemann, Milica Uvalić, Daniel Vaughan-Whitehead
And a CD-ROM containing Extended Country Reports
Research institute: Inter-University Centre at the Institute for Eastern European Studies, Free University of Berlin
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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 Hetter Kelso and Larry G. Lyon. For individual countries' chapters of the PEPPER III Report, an extensive use was made of the Extended Country Reports prepared for the Workshop 'Financial Participation of Employees in the New Member and Candidate Countries' (May 2005, Split, Croatia). These reports, being the result of an interdisciplinary research by economists and lawyers, are included in a CD-ROM attached to the PEPPER III Report and were written by (first line economists, second line lawyers):

Bulgaria	Spartak Keremidchiev, Bulgarian Academy of Science, Sofia
	Stela Ivanova, Institute for East European Law, Munich
Croatia	Srečko Goić, University of Split
	Darko Završak / Ratko Brnabić, University of Split
Cyprus	Christos Ioannou, OMED Athens
	Loizos Papacharalambous, Papacharalambous & Angelides, Nicosia
Czech	Lubomír Lízal / Ondřej Vychodil, CERGE-EI, Prague
Republic	Stephan Heidenhain, bnt - Pravda, Noack & Partner, Prague
Estonia	Niels Mygind, Copenhagen Business School / Raul Eamets, University of Tartu
	Natalia Spitsa, Inter-University Centre, Free University of Berlin
Hungary	Dorottya Boda / László Neumann, National Employment Office, Budapest
	Zoltan Vig, Central European University, Budapest
Latvia	Tatyana Muravska, Centre for European & Transition Studies, Riga / Niels Mygind (s.a.)
	Theis Klauberg, bnt Legal and Tax Consultants, Riga
Lithuania	Valdone Darskuviene, Vytautas Magnus University, Vilnius / Niels Mygind, (s.a.)
	Stefan Hanisch, Inter-University Centre, Free University of Berlin
Malta	Saviour Rizzo, University of Malta, Valletta
	David Borg Carbott, Ganado & Associates - Advocates, Valletta
Poland	Richard Woodward, CASE Foundation, Warsaw
	Jens Lowitzsch, Inter-University Centre, Free University of Berlin
Romania	Lucian Albu, Romanian Academy of Sciences, Bucharest
	Axel Bormann, Institute for East European Law, Munich
Slovakia	Lubomír Lízal / Alexander Klein, CERGE-EI, Prague
	Christine Goecken, University of Cologne
Slovenia	Aleksandra Gregoric, University of Ljubljana
	Sime Ivanjko, University of Ljubljana
Turkey	Elif Tunalı /Yasemin Atasoy, Capital Markets Board of Turkey, Antalya
	Kaya Gönencer, French Corporate Governance Association, Paris

Technical editors Natalia Spitsa and Stefan Hanisch

The Report is divided into three parts. The first part consists of an overview chapter which provides a summary of the development of employee financial participation in the countries under consideration, as well as chapters on the experience of employee financial participation in Western Europe and its relevance in the framework of the European integration process. The second part consists of country chapters, each covering four main issues: the general environment for employee financial participation, highlighting the background, the attitudes of social partners as well as government policies; the legal foundations for different forms of participation, including the incentives for application of schemes; available information on the incidence of various financial participation schemes; and the empirical evidence on the performance of companies with varying degrees of employee participation. The third part of the Report outlines the way to a European platform for financial participation.

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Garystr. 55, 14195 Berlin, Germany - Telephone: (+49 30) 8385 33 80 / 20 61 - Fax: (+49 30) 8385 37 88
Email: zentrum@zedat.fu-berlin.de - Website: www.intercentar.de

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European Foundation for the Improvement of Living and Working Conditions
Wyattville Road
Loughlinstown
Dublin 18
Ireland
Telephone: (+353 1) 204 31 00
Fax: (+353 1) 282 42 09 / 282 64 56
Email: postmaster@eurofound.eu.int
www.eurofound.eu.int

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Foreword

Two years after the 10 new Member States joined the European Union, it is clear that the enlargement has acted as a catalyst of economic dynamism and modernisation for the EU, helping the economies of old and new Member States to face better the challenges of globalization, while the predicted major shocks or disruptive impacts have not taken place. However, important challenges remain for both old and new Member States, namely the ageing population and the strain it puts on public finances and the further increasing global competition. The European Commission has estimated that population ageing will reduce potential growth in the EU-15 to one half of the current rate over the next 25 years, that is from 2.25% to some 1.25%. For the recently acceded Member States, the adverse impact on population ageing on growth will even be more pronounced.

To address both challenges, we need to enhance the productivity and competitiveness of our economies, making the EU a more attractive place to invest and work in. The framework conditions set by legislators are an important factor enhancing innovation and entrepreneurial activity, productivity, and finally growth and jobs. The EU strategy for growth and jobs, which is also known as the 'Lisbon strategy', lays out an integrated framework to bring this about. This spring, the EU leaders agreed to focus their action in particular on four areas: knowledge and innovation; unlocking the business potential, including promoting SMEs; employment policies; and a common EU energy policy.

In the area of employment, the strategy for growth and jobs aims at raising the employment rate in the EU to 70% of working age population. The envisaged measures include increasing flexibility on the labour market, while providing a level of security and lifelong learning that will enable people to adapt to challenges in their working life. The possible measures may include elements such as flexible contractual arrangements from the perspective of employers and employees; active labour market policy; efficient lifelong learning systems; modern social security that combines the provision of adequate income support with the need to facilitate labour market integration, mobility and transitions. A stronger link between pay and performance can be one of the possible ways to reform the labour markets. Such performance pay schemes can come in many forms. Employee participation in profits and enterprise results is one possibility to entice workers to be productive and adaptive to change.

The systematic approach followed in this PEPPER III Report will help to deepen our understanding of the pros and cons of financial participation schemes. The country-specific analyses can serve as a tool for the exchange of best practices, and this report can be helpful in facilitating mutual learning among the Member States. I hope that the experiences with financial participation schemes in the new Member States and the Candidate Countries as presented in this PEPPER III Report will serve as a catalyst for new developments and dynamism in other EU countries and thus deliver a contribution to the success of the reviewed strategy for growth and jobs in the EU.

Brussels, October 2006

Günter Verheugen,
Vice President of the European Commission

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In Hungary employee ownership has been the most frequent form of employee financial participation with the Hungarian Employee Share Ownership Programme (ESOP)[200] still being prevalent. Although it spread quickly in the early phase of privatisation, the relative weight of this ownership form in the whole of the economy is not significant. With privatisation complete, the number of ESOP companies has been decreasing relatively quickly. Other PEPPER schemes in the context of privatisation as well as in the context of incentive plans, including profit-sharing, have taken place only to a limited extent. They did not receive any economic policy support – and consequently pro%ral registration systems do not exist. An exception is the 'Approved Employee Securities Benefit Programme' introduced by tax laws in 2003. At the same time traditional forms like cooperatives play an insignificant role in the economy and in employment as well.

1. General Attitude

Employee ownership in Hungary began with the Workers' Councils of the 1956 revolution.[201] It continued with the reforms of 1968 ('New Economic Mechanism') which introduced a set of new elements of incentives and became full-fledged in 1984 with the partial employee ownership of companies, when 'market co-ordination' (Kornai, 1985) replaced the re-distributive and bureaucratic socialist economic system. As a first step in the reform measures of 1968, profit-sharing was introduced, which became part of the centrally set wages in state-owned companies.[202] One of the antecedents of employee ownership in Hungary was the Enterprise Business Partnership (VGMK), possible from 1982.[203] Finally in 1984 the self-government of companies was institu-

[200] 'Munkavállalói Résztulajdonosi Program' (Employee Share Ownership Programme), MRP – by its Hungarian abbreviation, ESOP hereafter, is a form of employee ownership based on the US ESOP.

[201] 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).

[202] By the time of the change of the regime, however, the use and size of profit-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.

[203] VGMKs were 'intrapreneurial' businesses of core workers in which on the one hand work organisation was improved through the 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 and Borbély, 1988).

tionalised.[204] The first important step towards the introduction of a market economy in Hungary was the Law on Business Associations of 1988 which allowed large State companies to be transformed into limited liability companies and joint-stock companies. Even before the transformation, during the period of 'spontaneous privatisation', a decree of the Ministerial Council[205] allowed employee ownership by means of *property notes*. The growing need for legal control of privatisation resulted in the adoption of a privatisation law and the establishment of the State Property Agency. Employee-ownership was mostly a policy priority in the interests of social justice and equity thus it could only become a realistic option when privatisation demand shrank and/or the popularity of privatisation seemed intolerably low.[206] The privatisation 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 privatisation period.

Trade unions participated at a national level in the promotion of the various forms of employee ownership. Local unions, however, were often surprisingly passive and limited action to declaring their interest in employee buy-outs but did not play any role in organising the procedure; in other cases, however, local trade unions actively lobbied for preferential shares as well as for ESOP buy-outs. In addition to influencing privatisation decisions, unions usually had at least one of their leaders as a member of the organising committee and the ESOP trust. Subordinates saw ESOP and other durable buy-out schemes as a tool to preserve their workplace. An important number of employees regarded employee ownership as the only acceptable form of privatisation in order to avoid foreign ownership. At the expense of meeting tough profit requirements, ESOPs were a good possibility to enable the management to preserve the comfortable position they had gained in the 1980s when some of the ownership rights were exercised by Enterprise Councils and Assemblies made up of company managers and subordinates.[207] Furthermore, the cooperation of managers and subordinates in ownership was in line with Hungarian traditional intra-enterprise relations.

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[204] State enterprises were managed by Enterprise Councils or Assemblies elected by the workers. Transferring part of the ownership rights to these bodies further increased company autonomy vis-à-vis Communist party-state regulation, and put the management in quasi owner position without real control by owners.

[205] Decree of the Ministerial Council No. 94 of 1988 on Property Notes. Companies could issue such property notes free of charge for employees only using the after tax profit, up to a maximum of 10% of the total assets of the company. However, such property notes were issueable only until May 15, 1993. Later they were transferred either into shares or companies were obliged to buy them from their owners. See Boda and Neumann (1999), p. 40.

[206] With the appearance of mass unemployment in 1991, employee ownership increasingly seemed to be a tool for the company to continue operations and for keeping human resources and jobs.

[207] According to the memories of a former leader of the Rész-vétel Foundation representing ESOP companies, about half of company managers used an ESOP as the cover for a management buy-out. Half of the rest of the managers realised over time that they did not really have to share ownership with their subordinates. The remaining one quarter behaved in a 'fair' way (Boda, Neumann and Vig, 2005)

Since the end of privatisation in 1998 lobbyists have been fighting without any success for political support and financial encouragement for ESOPs 'outside privatisation' as well as to make the technique applicable in cases of liquidation. Furthermore, in contrast to the international trend of the individual account-based pension system, plans to encourage tying employee ownership to pension fund membership have so far gone unnoticed. Another important effort of lobbyists was to amend laws (ESOP and tax laws) to make sure that the unfavourable economic environment would not undermine the operation of existing ESOP enterprises.[208] The latest example is placing outpatient health care services and the organisation of ESOP companies on the privatisation agenda. Nevertheless, there is a great deal of uncertainty around the programme, not least because of the recent referendum on the ban on the privatisation of the health care system. 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 privatisation that mobilised and divided the whole society.

2. Legal and Fiscal Framework

The Hungarian Labour Code states that an employer may grant any benefit to its employees if it is provided in a non-discriminatory manner.[209] In Hungary, the legal framework of financial participation of employees embraces both, profit-sharing and employee share ownership. However, specific (legal/tax) incentives for profit-sharing do not exist, neither for employees nor for employers. Company law regulates employee shares, including stock options, explicitly and recently an 'Approved Employee Securities Benefit Programme' including specific incentives has been introduced.

a) Share Ownership

Employee privatisation on preferential terms (1991, 1995) – The privatisation law of 1991 contained various preferential privatisation techniques. In 1995 a new Law on Privatisation[210], still in force, reduced some of the allowances for employees, but at the same time offered new forms and techniques, i.e. privatisation on deferred terms, em-

208 Early regulations focused on asset acquisition, and questions of distributing and balancing power at that time did not allow the operational problems to be addressed.

209 Section 5 of Law XXII of 1992 on Labour Code.

210 Law XXXIX of 1995 on the Realisation of Entrepreneurial Property in State Ownership. In practice, one of the problematic issues was how to secure financial sources for preferential privatisation. Another issue was that the State Property Agency was organised 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.

ployee privatisation on preferential terms, *'Egzisztencia'* credit and ESOPs. In the context of privatisation three financial techniques for acquiring employee ownership on preferential terms exist: (1) price reduction, (2) purchase by instalment and (3) purchase on credit. Thus it is possible to grant a discount of up to 150% of the annual minimum salary. 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 an organised form.[211] Payments on deferred terms for privatised property may be granted for a maximum period of fifteen years.[212] The interest rate on such credit cannot be less than 50% of the current official national bank interest rate while ownership passes to the buyer with the payment of the first instalment. Furthermore Hungarian citizens may take up to 50% of the property that they wish to acquire and as a maximum up to 50 million HUF as an *'Egisztencia' credit*[213], regardless of the number of buyers.[214] The law also sets up criteria for the eligibility of taking such credit, e.g., that the property bought on credit may be alienated only with the consent of the credit institution until the credit is repaid and that the same applicant may take credit only once within three years.

Employee stock ownership programme (1992) – In Hungary [215] the American ESOP system had a strong influence on the drafting of the law regulating the establishment and functioning of ESOPs. Basically the Hungarian ESOP followed the American 'trust' model (Luxne and Szucs, 1993, p. 9; Boda and Neumann, 1999, p. 45). However, there is a major difference between the two systems: while in Hungary the ESOP is a privatisation form with the organisation ceasing to exist as soon as all the securities are paid for and their ownership is transferred to the employees, in the United States, an ESOP is an organisation that administers the securities of employees and does not cease to exist when the credit is repaid.[216] Hungarian literature distinguishes between so-called 'privatisation' and 'non-privatisation' ESOPs (Szakértői Munkaközösség: ESOP, 1990, pp. 49-50). In the case of the former, the ESOP or-

211 Section 55-57 of Law XXXIX of 1995 on Realisation of Entrepreneurial Property in State Ownership.

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

213 Governmental Decree No. 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits; see below c).

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

215 Regulated by Law XLIV of 1992 on Employee Share Ownership Programme, which entered into force on July 14, 1992, amended with Law CXIX of 2003.

216 For the ESOP organisation that exercises ownership rights, basically the American 'trust' model was used (see Boda and Neumann, 1999, p. 45; Mocsáry, 1998, p. 63). Another difference between the American and Hungarian regulation was 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 does not differentiate between employees and managers.

ganisation buys the property of the State Property Agency or of 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 the State Property Agency are sold, e.g., already existing securities or securities issued in the case of capital increase also foreseen by the ESOP law. The only difference between both forms is that there are no specific incentives encouraging companies or employees to establish non-privatisation ESOPs.

Participants of an ESOP have to be employed by the given company for at least half of the official work time and need to have an existing employment contract with the company for at least six months.[217] An employee can be a member of only one ESOP organisation at a time, though it is possible that within one company two ESOPs exist since there is a threshold of 40% employee participation. Until an amendment of the law in 2003 retired employees had to secede from the ESOP[218], now they can decide if they wish to remain a member. New employees or old ones who did not want to join the organisation at the time it was established can become members of the ESOP at any time. The employees of the company elect a three member organising committee whose duty is to negotiate with potential sellers (company) and creditors (e.g. banks)[219] and subsequently to prepare the credit application and purchase offer. The committee is also responsible for the preparatory legal work relating to the establishment of the ESOP organisation, e.g. drafting the proposal of the statutes.[220] At the statutory meeting ESOP members elect its board, as with the establishment of the organisation the organising committee ceases to exist. Upon registration the organisation becomes a legal entity, being a non-profit organisation under the supervision of the Office of the Public Prosecutor[221] with the members' meeting as its highest decision-making organ.

The organisation ceases to exist when the ownership of all shares is transferred to the participants of the ESOP, unless the employees decide that the ESOP organisation should remain, which requires them to develop regulations for the period after repayment (e.g. rules of marketing shares).[222] The organisation has full liability for its obligations. Members of the organisation are not liable for the debts of the organisation except with the securities already allocated to them. Until the shares are transferred to

217 A longer period up to a maximum of five years can be required by the statute of the ESOP organisation; see Section 1 (2) of Law XLIV of 1992 on Employee Share Ownership Programme.

218 Because of long repayment periods this was disadvantageous for these employees, as they could not have their share of the profit (Mocsáry, 1998, p. 68).

219 The committee also prepares a feasibility study, in which it examines the financial situation of the company checking if the company will be able to carry the financial burden of the programme; the study has to be countersigned by the representative of the company.

220 At least 40% of the employees of the company have to agree on the establishment of the ESOP organisation and adopt the statute of the organisation.

221 Id. Section 11; it may pursue only limited economic activity (see note 38).

222 As a result of legal regulations, the overwhelming majority of ESOP organisations ceased to exist after the loans were repaid. Furthermore, the established forms of operating the asset (such as setting up a limited company) involve considerable costs (Boda, Neumann and Vig, 2005).

the participants of the ESOP[223] the organisation is the owner of the shares. With regard to the exercise of property rights, participants have voting rights in proportion to their registered shares, but up to a maximum of 5% of the property acquired by the ESOP organisation.[224] However, in many issues related to decision-making in an ESOP organisation the law gives a wide discretion to the members of the organisation to establish 'internal' rules in this field. 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.

In the case of 'privatisation' ESOPs only credit is available to employees on preferential terms, however, the own resources of the organisation must be at least 2%.[225] If the securities of limited liability companies or joint-stock companies in majority state ownership are sold by the State Property Agency the ESOP organisation can offer preferential credit or an instalment payment plan.[226] The terms of the credit[227] are as follows:

Amount of credit	**Own resources (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 on the credit has to be paid.

Tax exemptions for 'privatisation' ESOPs allow the company to offer tax allowances for the property sold to the ESOP organisation prescribed by the Corporate Tax Law (Lukács 2004, 9.5.2.5). Accordingly, up to 20% of the amount paid to the ESOP organisation can be deducted 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 taxable income of the organisation.[228] 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 the amounts of subsidy paid in by other private or legal persons, or by the employer company (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 participants of the

223 As in the Anglo-American model, following the payment of shares employees may dispose freely of his/her shares (Boda and Neumann, 1999, p. 26).

224 Section 7 (6) of Law XLIV of 1992 on Employee Share Ownership Programme.

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

226 Section 15 (1) of Law XLIV of 1992 on Employee Share Ownership Programme.

227 Section 8 (2) of the Governmental Decree No. 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits.

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

ESOP – on the pretence of transferring means without compensation, that amount is accounted among expenditures (reducing the profit) according to the rules of accounting.[229] According to Personal Income Tax Law, the securities transferred from the company to employees are tax free, such securities are not considered as income.[230] However, at the time of sale of such securities by the employee, the income from this sale is considered a capital gain and taxable at a rate of 20%.[231]

Private Companies (1988) – Employees' shares were first introduced by the Law on Business Associations of 1988[232] and still exist under the current version of the law[233]. They are registered shares and can be issued free of charge or at a reduced price in accordance with the provisions of the Articles of Association of the joint-stock company, e.g. in the context of a Long-Term Incentive Plan or a broad-based Stock Option Plan. Employees' shares may be issued with a simultaneous share capital increase of the joint-stock company, up to a maximum of 15% of the increased share capital. 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 amongst shareholders prior to the shares belonging to other categories or classes of shares, but following shares granting preferred dividends. In the event of the 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. 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 in its share capital, or shall decide to sell such shares after transforming them into ordinary, preference or interest-bearing shares. Thus, the limited transferability of this kind of share reduces its value.[234] The company issuing such shares can distribute them for free or give discount for their purchase, which makes this form of financial participation very attractive for employees. However, there are no tax incentives related to this form of share acquisition (Lukács, 2004, 9.5.1.3). From January 1, 2003 income received in the form of securities is no longer regarded as an allowance in kind. The applicable rules of taxation are determined by the legal relationship between the private person and the provider. In the case of securities provided by employer to employee, such income is considered as income from employment, and the pertinent tax rules have to be applied.[235] Thus, in case of employ-

[229] See Foldes 573 (2005).

[230] Section 18 (4) of Law XLIV of 1992 on Employee Share Ownership Programme.

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

[232] Section 44 of Law VI of 1988 on Business Associations.

[233] Section 187 (1) of Law CXLIV of 1997 on Business Associations.

[234] According to research undertaken by the National Employment Office of Hungary, employee share ownership is insignificant in Hungary. Interview with Dr. L. Neumann (Budapest, February 10, 2005).

[235] 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).

ees' shares, the difference between the purchase price and the sale price falls under personal income tax.

Approved Employee Securities Benefit Programme (2003) – In the beginning of 2003 new legislation[236] entered into force allowing companies to set up state-recognised, tax-qualified stock plans. The organiser of the Employee Securities Benefit Programme has to submit an application for the recognition of the programme as an approved programme to the Ministry of Finance which informs the competent Tax Authorities about its decision. To be approved, the programme must meet a catalogue of conditions, e.g., that only securities issued by the applicant company or by its majority shareholder may be offered in the programme and the statutory threshold levels of at least 10% employee participation and a management share of less than 25%, with less than 50% of the total share value. 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.[237] 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. Any shares deemed non-qualified are taxed as normal employment income.[238] Once employees exercise the shares, the shares must be held in a security account overseen by a custodian, and there is an obligatory three year vesting period which ends on December 31 of the second year subsequent to providing the securities.[239] Following this, they have the same rights as any other shareholder from the same class.

b) Profit-Sharing (1992)

Except for section 5 of Law XXII of 1992 on the Labour Code, which states that an employer may grant any benefit to its employees if it is provided in a non-discriminatory manner, no regulations exist. Specific incentives do not exist, neither for employees nor for employers. There is no tax allowance or other kind of state subsidy in the case of profit-sharing, every kind of benefit and allowance paid to employees falls under the Personal Income Tax Law and there is also no allowance for employers. Apart from the lack of incentives, the origin of this form of financial participation as an evolution of pay systems is not common to socialist economic systems and explains its absence.

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236 Law CXVII of 1995 on Personal Income Tax; Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Programme, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

237 While personal income tax is payable because the shares are regarded as earned income, no social security contribution must be paid (earlier share benefits were regarded as in-kind benefits, belonging to the highest income tax bracket (44%), and the social security contribution was also payable).

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

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

c) Cooperatives

In the same way as the previous Law on Cooperatives of 1992[240], the Law on New Cooperatives[241] requires a minimum of five persons (both natural and legal persons)[242] to establish a cooperative.[243] Unlike the 1992 Law the new Law does not place much emphasis on the property notes representing shares in the cooperative. It only states that the membership and membership rights and duties are represented by property notes representing rights in the cooperative. The new Law obliges the cooperative to keep a register of members and their contributions. However, the Law states that irrespective of their contribution, members have the same rights in the cooperative. The members' meeting decides on the dividend (on the proposal of the board of directors and the supervisory board) based upon economic cooperation with the members. The highest decision-making body of the cooperative is the members' meeting; it is convened by the board of directors and any issue may be put on the agenda on the initiative of at least 10% of all the members. Concerning quorum rules, at least half of the members have to be present, and if there is no contrary provision in the law, 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. 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 the everyday activities of the cooperative. It forms the working structure, exercises employer's rights and makes decisions regarding every issue that is not in the competence of other organs. Regarding taxation of the cooperative as an organisation, it is subject to the Law on Corporate Tax and Dividend Tax, and pays 16% tax on its realised profit. According to the provisions of the Law on Personal Income Tax, representing shares in the cooperative are considered securities and any income related to them is taxed accordingly.[244]

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240 Law I of 1992 on Cooperatives (the 'old' law).

241 Law CXLI of 2000 on New Cooperatives.

242 The Law does not allow the number of legal person members to be higher than that of natural persons, except if the majority of members are cooperatives.

243 At present both laws on cooperatives are in force, the 'old' one of 1992 and the 'new' one, that entered into force on Jan. 1, 2001; following this date, cooperatives can be established only in accordance with the provisions of the new Law. Cooperatives that existed prior to this can function in accordance with the old Law until Dec. 31, 2006; however, they have to decide by this date whether they will keep on functioning as a cooperative (in this case they have to adjust to the provisions of the new Law), transform into another form of enterprise or cease to exist.

244 Section 34 of Law CXVII of 1995 on Personal Income Tax. For tax rate see g) Taxation Issues.

3. PEPPER Schemes in Practice

In Hungary in recent years employee ownership has been on the decline (Boda, Neumann and Vig, 2005).[245] Employees mostly tended to sell their shares as quickly as possible, especially if their ownership amounted to only a few percent, in order to realise what may be called 'a one-off privatisation bonus' rather than to hold on to their shares and demand participation in strategic and ownership decision making. More stable forms of employee ownership (majority shares packet, ESOP) were created where managers could promise fair treatment and promote the image of a company using redundancy measures only as a last resort. Empirical studies[246] investigating the privatisation process found that the main goal of the management in all cases was to keep the whole enterprise as one unit and by supporting employee ownership to avoid external ownership control, thus retaining their decision-making autonomy. Chances for the participatory form to be workable are greater if the relative capital need of the company (assets per head) is low and there are fewer employees. Full employee ownership is created where the activities of the enterprise are highly complex (high rate of non-repetitive products); also, there is a significant correlation between the demand for skilled labour by the company and the share of employee ownership.

a) Share Ownership

Employee privatisation on preferential terms – Between 1990 and 1992 employee ownership *on preferential terms* was created in 540 companies in compliance with the Asset Policy Guidelines and privatisation laws, typically at a level less than 10% (and nowhere more than 15%) of employee ownership share[247]. It was popular during the early so-called simplified privatisation to employees of small and medium-sized enterprises (Lukács, 2004, 9.5.1.1). In terms of privatisation as a whole, the 15%-shares of the assets of the various enterprises amounted to a significant total value. To give a sense of the order of magnitude, immediately after privatisation there were altogether HUF 13.9 billion worth of employee shares in the 9 privatised electricity companies[248]. In addition, according to expert estimates, between late 1989 and June 1992, i.e. prior

245 A panel survey made between 1992 and 2000 analysed the data of about 400 industrial production companies; in 1995 the share of employee ownership was 20% in the sample weighed by categories of number of employees and geographical location (Jánky 1999).

246 In 1993, on the request of the State Property Agency the findings of an empirical study were summarised. The study covered five early cases of ESOP programmes (Bodan and Neumann, 1999); Rozgonyi and Jávor (1996) researched the employee buy-out in five enterprises with different profiles in 1996.

247 Magyar Hírlap, 13 August 1992; unfortunately, there are 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 privatisation employees in almost all enterprises were offered preferential purchase terms.

248 ÁPV Rt. Annual Report 1996.

to the passing of the ESOP bill, employee and management buy-outs took place in about 30 firms (Karsai, 1993).

Employee Stock Ownership Programme - According to State Privatisation Company (ÁPV Rt.) records, between 1992 and 1999 287 ESOP purchases took place at a nominal value of about HUF 51 billion (Boda, Neumann and Vig, 2005). On average, in the early years (between 1989 and 1992) 85% of the employees became owners of their companies in buy-out transactions (Karsai, 1993)[249]. At the time of privatisation there were nearly 80,000 employees at the 247 enterprises involved in these transactions (Kubik and Matolay 1998).[250] The heyday of the ESOP was 1993 and 1994 with most transactions taking place at that time after a slow start; then an amendment to the law in 1995 put an end to the purchase of majority ownership on preferential terms.[251] On the whole, in 47% of cases recorded by the Rész-Vétel Foundation, the ESOP was a full or majority owner, and in 24% an owner with controlling rights (owning 25 to 50%).[252] The greater the capital a company had, it seems, the smaller was the share of ownership bought out by the employees[253], although studies show that the huge majority of ESOP buyouts were in practice management buy-outs (Galgóczi and Hovorka, 1998, p. 4).

However, during the last few years no new ESOPs have been established, partly because this form was linked to the privatisation of state property, and partly because of the lack of tax and other benefits related to the 'refreshment' of membership of ESOP organisations.[254] Restrictions concerning the scope of entrepreneurial activity prescribed by the law on ESOPs were also an impediment to their flexible functioning and further development (Mocsáry, 1998, p. 69). The new amendment to the ESOP law states that: 'the organisation can pursue other economic activities only to help to

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

[250] 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 the costs of buying were taken over by the company, almost all employees became owners, as in the majority of ESOP cases.

[251] 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.

[252] Rész-Vétel Foundation, Summary of ownership purchase by ESOP organisations 1995.

[253] Ibid. At the beginning, ESOP was a privatisation technique typically used in medium and small sized companies. Nearly two thirds (65%) of the businesses involved were medium size 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 over HUF 1 billion worth of capital.

[254] 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), relocating some employees to newly established companies that were separate legal entities, so that 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 (Mocsáry, 1998, pp. 68-70).

achieve its goals.'[255] Between 1993 and 1995, the ownership structure did not change much in the majority of ESOP companies bought through loans as the debtors could not sell their shares before full repayment of the loan. From 1996, however, both inside ownership and the ownership share of subordinate employees shrank considerably. Furthermore, according to the ESOP law, by-laws regulate the eligibility criteria for joining the ESOP organisation at a later time. In most of the companies, financial support for down payments was a one-time act limited to privatisation and late-comers were required to pay immediately.[256] As a result of legal regulations, the overwhelming majority of ESOP organisations ceased to exist after the loans were repaid.[257] According to HCSO data, in the first quarter of 2005 there were – including newly founded ones - only 151 ESOP organisations remaining.[258]

In summary it can be said that in 1998, the final year of privatisation, as little as one % of the 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 and joint stock companies) (Laky, Neumann and Boda, 1999). Of course, if one considers only privatised assets, the share of management and employee ownership was higher, especially in late 1993 when it amounted to 12%[259]. By September 2000 around one third of companies had repaid their loans. In over half of them employees remained the owners of their company, but when the ESOP organisation 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[260]. Loan repayment accelerated the shrinking of employee ownership: there are external owners in about half of the unencumbered companies, which is a sign of post-privatisation sale.[261]

255 Section 16 (1) of Law XLIV of 1992 on Employee Share Ownership Programme.

256 There is almost no 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 to the creation of 'exclusive' ESOP organisations (Boda, Neumann and Vig, 2005).

257 Between 1995 and 1999 the share of large ESOP companies employing over 1000 dropped to half. 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).

258 After mass privatisation was over there were about 300 ESOP organisations in 1998 and 252 in the first quarter of 2001.

259 In Mihályi's calculations, in 1993 assets sold by ESOP technique as per the contract price made up 16% of total annual privatisation revenue, and 32.0% of domestic sales (Mihályi, 1998).

260 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.

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

Private Companies – According to a study from 1992[262], up to mid-1991 the State Property Agency issued permission for 20 companies to issue free shares.[263] While employee shares might amount to 10% of the total value of privatised enterprises these forms of ownership were far from being stable as owners sold as soon as possible.[264] Trade unions pushing the management for preferential shares supported the resale by employees so actively that they looked for brokerage firms themselves.[265] The review of the current practices of long term incentives (Boda, Neumann and Vig, 2005) is based upon data from the above mentioned consulting firms. 37% of HayGroup clients gave their employees shares in 2004[266]; 90% of these enterprises have adopted the income policy of their foreign mother company and have supported the various forms of share benefits in their incentive policy. In these forms of participation, however, mostly managers were favoured as the aim of these long term incentives generally were to make top managers identify with the long term goals of the company, retain the key top managers and supplement employees'.[267] The majority (66.5%) of enterprises using employee share benefits offer employees Stock Option Plans; the share purchase programme is fairly widespread (33.4%). Stock Option Plans most often (62%) involve buying equity shares at the stock exchange, and 30% provide shares by issuing equity shares after commercialisation. Stock Option Plans last for a minimum of 1 to 3 years and a maximum of 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. These findings are confirmed by information from Hewitt Inside Kft, stating that in 2004 26% of enterprises used one long term incentive or another; most of them (80%) launched Stock Option Plans, and many (30%) used performance shares.

Approved Employee Securities Benefit Programme – In the two years since the legislation only 7 or 8 companies have applied and have been granted permission for

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

263 Preferential shares ranged from 1.15% to 16.3% of the company's registered capital (preferential shares were free or sold for 10, 50% or 60% of their nominal value.) Most commonly, employees could buy at 50%, payable by instalments. Company regulations on the purchase of preferential employee shares usually favoured managers as the limit was specified as a percentage of base wages.

264 There are no statistics on the sales of employee shares and only case studies provide information on what happened to them. The intention of employees to sell quickly was especially obvious in companies in which the share became, or were expected to be, quoted at the exchange market, and their value rapidly grew to several times higher than at the initial public offering (for instance: EGIS, MATÁV, MOL etc.).

265 See Magyar Hírlap, 2 May 1998; e.g., in the electricity industry the trade union concluded a deal on the preferential terms of employee ownership with the Privatisation Ministry prior to privatisation.

266 Source: Hay income level study 2004, Hay Group 2005, Hay Executive Compensation Report, Hay Group 2005.

267 No data is available on employees participating in company programmes. The low penetration of participation, however, is seen in the HCSO labour force survey data. Less than 1% or only 281 of 30,000 respondent employees received employee shares. Unpublished data, Hungarian Central Statistical Office (hereafter: HCSO) 2004.

Employee Securities Benefit Programmes, and the number of participating employees is not more than a few thousand. Typically the companies are relatively large multinational enterprises in Hungary that adapt the share benefit programmes designed by their headquarters for all their subsidiaries. Similar to the procedure made possible by Section 77/A and B, both adaptation of benefit schemes and application for permission is carried out by consultants 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 operational circumstances, incentive and wage systems in Hungary. The permission procedure itself is 'client friendly' in the sense that the application 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.

From the applications submitted by companies it appears that the typical scheme is a free share programme. 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 upon position in the hierarchy rather than on performance indicators (Boda, Neumann and Vig, 2005). In the Ministry's evaluation, the main motivation for using the scheme is low taxes, which is also available with other in-kind benefits (for instance support of voluntary insurance payments, tax free up to the amount of the minimum wage – currently HUF 57,000 per month – and which can be used immediately for health care services).

b) Profit-Sharing

In traditional Hungarian state socialism[268], profit-sharing was a flexible element of income in addition to the basic wage and many domestically owned companies still use this practice. Multinational or foreign owned companies, however, pursue their own methods developed inside the mother company. Some foreign owned companies in Hungary apply the American incentive model which is highly profit-oriented and focuses on incentives for the management (thereby creating 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.[269] 20% of them use profit-sharing. In most cases (in 67% of

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268 See Bódis, Emberierőforrás-gazdálkodás: módszerek, problémák, törekvések [Human resource management: methods, problems, aspirations], web page visited: January 12, 2005 <http://www.rezler-foundation.hu/docs/bodislajosharom.doc>.

269 The incentive systems of 50 companies were surveyed 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 production, 27% were service providers and 27% were trading companies. In their systems, the contingent wage included short and long term incentives and social and other benefits. A similar study by the HayGroup analysed wage data of 201 mostly foreign owned companies (82%).

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 incentive is the 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.

c) Cooperatives

Between the two world wars there was a considerable cooperative movement in Hungary. Credit cooperatives, which financed craftsmen, agricultural trading and crop manufacturing cooperatives were especially important. In the command economy, cooperatives, like the state sector, were put under central control and were integrated into the system of institutions of the all-embracing central distribution. The artificially inflated cooperative sector employed about 25% of total employment during the socialist period. With the approaching change of regime, the rate of cooperative members dropped somewhat, to 12.1% of total employment in 1989 (Statistical Yearbooks, 1987, 1990; HCSO, 1998, 2000).[270] Surviving and restructured cooperatives, however, play an insignificant role in the economy and in employment as well. According to HCSO data, on 31 December 2004 out of the 416,000 active incorporated enterprises there were 5,219 cooperatives in operation in the country but 2,607 of them did not employ anyone and operated purely as an organisation of owners. (A typical solution in consumer cooperatives is that the real economic activities were transferred into a business organisation and thus control by the membership became only a formality.) 36% of existing cooperatives work in services, 30% in agriculture and 19% in trade.[271] Currently employment by the cooperative sector is insignificant: according to data by the HCSO Labour Force Survey, in 2004 only 0.2% of the employed were income earning cooperative members.[272]

84% of all companies give their employees some kind of contingent wage made up of bonuses/premiums, profit share, and turnover bonus in sales jobs.

270 69% of cooperative members worked in agriculture, 22% in manufacturing, and 5% in construction.

271 HCSO (ed.) (2001, 2004), A gazdasági szervezetek száma [Number active undertakings], Budapest.

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

4. Evidence of the Effects of PEPPER Schemes

There is little empirical experience of the use of forms of participation not centrally supported because companies consider it to be their own affair. The use of the new 'Approved Employee Securities Benefit Programme' has had little impact so far. Thus, information is mostly available on the working of ESOP companies. The most interesting aspect of the division of assets between 'inside' buyers is the proportion of ownership between the management and 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): in almost half (48.9%) of the companies dominated by employee and management ownership, the share of management ownership is 50% to 99%. After loans were repaid, subordinate employees became 'free' owners and mostly sold their shares to managers. The concentration of shares sooner or later leads to majority management ownership even in companies where this was not the original case.

The ESOP law grants full autonomy for ESOP organisations to create their own rules. In practice, however, the by-laws of ESOP organisations mostly apply the model of a business rather than of a cooperative, consequently decision-making is based upon voting according to individual payments and the ratio of shares, and only rarely on a 'one member - one vote' basis.[273] 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. In most companies the Chief Executive Officer or his/her deputy or other confidant is an important member in the ESOP organisation, too. 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 manager. In most companies owners were unable to prevent the management from pursuing restructuring and redundancy plans even if they wanted to. According to another study (Rozgonyi and Jávor, 1996), even if strategic issues are put on the general assembly agenda, employees seem to be much less interested in those rather than in issues directly affecting them (e.g. work conditions) or in decisions on redundancy or work organisation that potentially have negative consequences.

An 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 services were especially competitive. According to data from 2000,

[273] 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 (Boda, Neumann and Vig, 2005).

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. Kovách and Csite (1999) found that enterprises in employee ownership (owned by entrepreneurs and by employees and management) in 1996 were more efficient than other ownership forms in terms of per assets sales revenues and realised considerable revenues even with few 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.

In summary, the employee owned companies operating most successfully were privatised 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 revenue, efficiency and liabilities since 1990, the financial management of the majority of small and medium-sized MEBO and ESOP companies seem to be solid and efficient. Large enterprises were the worst performing ones. Failures were due to large debts, incurred independently of privatisation, 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 efficiently 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.

As for human resources management, no ESOP company was found to have gone bankrupt because of employment or wage decisions made in favour of employees. In fact, redundancy was more frequent in ESOP companies than in other enterprises. The trends in companies with other forms of employee ownership are similar: redundancies were the greatest in employee-management owned companies between 1993 and 1996 (Kovács und Csite, 2002). Wage outflow does not seem to be a problem in ESOP companies either. The projected growth index of average earnings in 1999/1998 was almost identical in the two categories of companies.[274] With regard to asset management, data suggests that the financial situation of surveyed ESOP companies worsened (Boda, Neumann und Vig, 2005). 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 the figures of overdue receivables were worse. In September 2000 one third of companies had completed their loan repayment and only one company was still in a grace period. Apart from losing companies, these companies amortised the loans on

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

time; moreover paying the instalments seemed to be more important to 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 in 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 und Neumann, 2002).

Annex

Taxation Issues

Personal income tax in Hungary is based upon a progressive scale[275] 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

Tax on dividends is 20%, but for example the tax on allowances in kind is even higher, at 44%.[276] Capital gains are taxable at a rate of 20%.[277] The Corporate Tax rate is 16% tax on realised profits.[278]

275 Section 30. of the Law CXVII of 1995 on Personal Income Tax

276 Section 66 (8) and 69 (4) of Law CXVII of 1995 on Personal Income Tax.

277 Section 66 of Law CXVII of 1995 on Personal Income Tax; securities acquired from already taxed personal income of the participant of the programme are not taxable.

278 Law LXXXI of 1996 on Corporate Tax and Dividend Tax.