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Political Economy of Privatization in Hungary: A Progress Report

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September 1996

Abstract

This paper focuses on the political economy of privatization in its second phase in Hungary, the country which, overall, has gone furthest in privatizing public utilities, introducing elements of competition and setting up regulatory mechanisms and institutions to monitor them. The background to Hungary's reform path, the antecedents to privatization, the debate on the issues, the institutional framework and the progress of privatization in Hungary up to late 1993/early 1994 are well-documented elsewhere, including by the present authors. Therefore, the paper presents a brief review of the evolutionary path of Hungary's privatization "vision", policy and strategy under the government of József Antall (1990-1994), and attempts to identify the factors influencing this evolution. Developments regarding privatization under the reform- socialist/liberal coalition government led by Gyula Horn, which came to power in 1994, and a detailed examination of the privatization of the major utilities and the regulatory environment currently in place, forms the core of this study. Finally, the paper sets the above in the context of the overall development of the private sector in Hungary.

JEL Classification: D40, K21, L33.
Keywords: privatization, and regulation.

Acknowledgements

This paper has been prepared for the conference "The institutional framework of privatisation and competition policy in economies in transition", to be held at the CIS-Middle Europe Centre at the London Business School, September 19th and 20th 1996. Financial support from the ESRC and Coopers and Lybrand is gratefully acknowledged. The papers in this series are the preliminary results of research undertaken by members of and visitors to the Centre for Economic Reform and Transformation at the Department of Economics, Heriot-Watt University, and their colleagues working on CERT projects. They are published in this form to stimulate discussion and comment

on work that is generally still in progress.

1. Introduction: a brief review of the issues

"Stabilize, liberalize, privatize!" declared the International Monetary Fund and the World Bank, along with most western analysts, when the communist regimes collapsed in Central and Eastern Europe (CEE) in 1989-90 and these countries embarked on a process of transformation from central planning to market economy. The CEE countries without exception set about putting these three precepts into practice as key policy objectives, albeit with significant differences between countries in speed, sequencing and in the actual methods adopted.

At root, the transformation from socialist central planning to a market economy entails a radical adjustment in order to create a "new balance of power between the state and civic society, in favour of the latter" (Havas, 1996). In this light, privatization is arguably the most important, and probably the most complex element of the transformation process. This is because privatization, broadly defined as the transfer of state-owned assets to private ownership, alongside the creation and fostering of *de novo* private businesses, is about the (re)distribution of property (wealth) and the means of generating wealth. Hence, ultimately, it is about the longer-term distribution of economic and political power. Decisions related to privatization impinge on almost every aspect of the transformation process. They profoundly affect the future shape of the country's economy and its performance both on the domestic and international markets. In the CEE context, privatization involves a huge upheaval at every level of society: changes in regional patterns of economic activity, in the labour market, and, at the same time as a new class of entrepreneurs, property owners and shareholders emerges, some social groups will almost inevitably find themselves excluded or marginalized. Policy misjudgements or mismanagement could have grave consequences for social cohesion, threaten the consensus for reform as a whole and seriously undermine the country's political stability. Privatization thus brings a myriad of interest groups to the fore and into confrontation with each other.

The state itself must be regarded as a conglomeration of different interest groups, comprising the political forces in power (dominant ideological bias); the ministries (industry lobbies); the state bureaucracy (which exercises influence via the collection and processing of information and through the implementation of government decisions). The willingness of the state to relinquish ownership (control) of corporate assets and its ability to manage this process in a transparent and even-handed manner are thus also a litmus test of the credibility and efficiency of the fledgling democratic regimes' decision-making systems and implementation structures.

If these observations regarding privatization in transition economies are valid in general (and they are echoed by numerous analysts, e.g. Voszka 1994, Canning and Hare 1994, Havas 1996) nowhere are they more pertinent than in the "second phase" of privatization, whose central element has been the fate of "strategic companies", most notably the public utilities in CEE countries. Why? Because sectors such as energy generation/production and supply, transport, telecommunications, water, along with the large commercial banks, sections of the chemical industry, and in the case of Hungary, the aluminium industry, formed both the ideological core and the economic power base of the socialist economies. Their ideological importance derives from the fact that these sectors were crucial in order to be able to deliver on various social (political) objectives: e.g. ensuring availability of energy to all at low prices (energy prices to domestic consumers were kept lower than in the case of industrial consumers, and notoriously far below the marginal costs of supply); or to be able to control, in the case of telecommunications (including broadcasting), the flow of and access to information. Their economic importance stems from their character as vital inputs into almost all other productive activities and, in the case of the public utilities (incl. transport), from their direct contribution to consumer well being.

This paper focuses on the political economy of privatization in its second phase in Hungary, the country which, overall, has gone furthest in privatizing these sectors, introducing elements of competition and setting up regulatory mechanisms and institutions to monitor them. The background to Hungary's reform path, the antecedents to privatization, the debate on the issues, the institutional framework and the progress of privatization in Hungary up to late 1993/early 1994 are well-documented elsewhere, including by the present authors.[2] Section 2 therefore confines itself to presenting a brief review of the evolutionary path of Hungary's privatization "vision", policy and strategy under the government of József Antall (1990-1994), and attempts to identify the factors influencing this evolution. Developments regarding privatization under the reform-socialist/liberal coalition government led by Gyula Horn, which came to power in 1994, are described in Section 3. Section 4 forms the core of this study, examining in detail the privatization of the major utilities and the regulatory environment now in place. Section 5 sets the above in the context of the overall development of the private sector in Hungary, and some conclusions are drawn in Section 6.

2. Evolution of privatization in Hungary 1990-94

Attitudes to and understanding of the issues underlying the privatization of state-owned enterprises (SOEs) in transition economies have evolved and changed since 1990,[3] bringing concomitant changes in the focus of privatization policy and continuous modification in the strategy, pace and methods adopted. While many of these changes were pragmatic and well-founded (in response to changes in the broader economic environment; realization that targets set were unrealistic, etc.), other developments can be clearly attributed to political influences/ social pressures.

The privatization policy initially adopted by Hungary's first post-socialist government (led by the centre-right Hungarian Democratic Forum), which came to power in May 1990, was characterized by the following principal features:

$ emphasis on *economic* efficiency gains rather than political goals, e.g., in the immediate term, to reduce subsidies and increase revenues, thus easing the budget deficit; and, in the longer term, to improve microeconomic efficiency (and thereby the performance of the economy in general) through the introduction of "genuine" private owners (profit motivation, competition, innovation, expansion of the private sector);

$ emphasis on *commercial* privatization (i.e. sale of assets rather than free distribution to the public), maximizing revenues to the treasury; reorganization (i.e. demerger or separation of non-core activites/physical assets for sale separately) was not initially given much consideration; restructuring (i.e. internal organization, staffing, technology and processes, product profile, etc.) was deemed best left to new private owners;

$ emphasis on involving *larger* (strategic corporate; institutional) *investors*, and attracting *foreign investors*, with a view to bringing in the capital and the technological and managerial know-how required in order to achieve the economic goals outlined in the first two points above;

$ emphasis on relatively *gradual* privatization of state-owned corporate assets: the target set was to privatize 50 per cent of these assets (by value) by 1994; and

$ emphasis on *transparency* and accountability, in a *decentralized* framework where privatization could be initiated by: (1) the State Property Agency (SPA, set up in March 1990 under the reform-communist government of Miklós Németh to act on behalf of the state as owner in the supervision of transactions - e.g. incorporation, privatization - related to state-owned assets); (2) the enterprises; or (3) potential investors.

As early as July 1990, the government's position had altered in at least one significant respect: the SPA was made directly accountable to the government (rather than, as previously, to parliament) and decisions made by the SPA could not be appealed against through the courts. Enterprise councils (established in the mid-eighties as part of a package of initiatives aimed at decentralizing economic decision-making and giving enterprises more autonomy) were to be abolished; all enterprises were to undergo "transformation" (incorporation) by mid-1993, and the ownership/control rights transferred to the SPA. While on the one hand this served to clarify ownership rights prior to privatization, it also meant that enterprises were effectively renationalized. Privatization was, in effect, to be centrally managed. The first "showcase" privatization programme, launched by the SPA in September 1990, involving 20 major companies with reasonably good balance-sheets and prospects, was a resounding failure. While some of the lessons drawn from this led to modifications of other aspects of privatization strategy, centralization of asset-management and privatization have remained a hallmark of the Hungarian approach, albeit assuming subtler forms (see, e.g. Voszka 1991, 1994, 1996 for analysis of the centralizing tendency).

Other changes: from 1991, the emphasis (both in legislation and in practice) gradually shifted towards "safeguarding" state-owned assets, modernization, restructuring ("dirty dozen" - later 13 - firms granted special treatment; see OECD 1994); the need to accelerate privatization of state-owned assets came increasingly to the fore, and the political aim of creating and fostering a property-owning middle-class was mentioned fcr the first time.

The emphasis on maximizing budget revenue diminished and the use to which revenues from privatization were put shifted increasingly towards restructuring and financing schemes to foster smaller, domestic investors (away from easing the state debt and the budget deficit). Compensation (to individuals whose property or land had been confiscated for political reasons under the previous regime(s)[4]) and restitution (of church property) came on the agenda; municipalities were to be allocated properties/stakes in companies.[5] Favourable loan schemes were initiated to enable individuals to participate in the privatization process (Existence (E-) credits), especially the "small" privatization programme (also termed "pre-privatization" in Hungary) involving principally retail and catering outlets. Significantly, in the latter period of the Antall government's term in office, employee share ownership was given higher priority (initally only 5-10 per cent of company shares were set aside for purchase at preferential rates by employees) and supported by preferential loans. The terms attached to E-loans were eased considerably in 1993, and their use extended to cover participation in this and other schemes aimed at supporting local investors. Yet other schemes, e.g. "leasing" (amounting to privatization by instalments at a zero nominal interest rate, circumventing the need to take on a commitment to loan repayments) and management buyout/buyin opportunities were created or extended. Finally, in late 1992, just over a year prior to the next general election (May 1994), the government annnounced plans for a privatization scheme based on credit vouchers open to all Hungarian citizens over the age of 18, without risking their personal assets, with the avowed aim of creating "the widest possible range of domestic owners".[6] This so-called Small Investor Share Purchase Programme (KRP) was, in the end, terminated before it was fully implemented.

This distinct turnaround in policy in favour of "domestic owners" coincided with increasingly infrequent mention of attracting foreign investment, and the decision to end the considerable tax relief available to foreign investors with effect from January 1994.[7] It is not insignificant that from late 1992 and throughout 1993 serious rifts appeared between the three coalition parties, while acrimonious in-fighting took place between moderate and hard-line factions within their ranks, leading to a number of defections, a split in the Smallholders Party, and the ousting from the HDF of extremist demagogue István Csurka and a number of his followers in late 1993.[8] Hardly surprisingly, some of the most divisive issues in this period were those related to privatization (notably that of land), and particularly the participation of Hungarian citizens in the process.

It was not until July 1992 that the Antall government passed legislation on privatization and management of state-owned assets to replace the "Temporary Asset Policy Guidelines" in force since 1989. For the most part, policy and strategy were developed and modified during the intervening period on an *ad hoc*, piecemeal basis. Under the new Privatization Act (Act LIV of 1992), the extent of state ownership envisaged was widened. Around half the assets (in terms of value) originally slated for privatization were transferred to a new organization, the State Holding Company, established in October 1992 to manage assets which would remain partially or wholly in state ownership in the longer term for strategic reasons or, as in the case of the utilities, until such a time as the appropriate legislative and regulatory framework was in place and decisions had been reached regarding the most appropriate form of privatization (strategic or portfolio investors, etc.) and its scope.

Overall, between 1990 and 1994 a marked shift from decentralized to centralized privatization can be perceived; from strictly economic goals to more or less overtly political aims: creating a local property-owning class and (from 1993) winning electoral loyalty for the ruling parties, whose image had been tarnished by internal strife, extremist polemics (and a number of scandals involving property deals).

Despite the problems, however, (and it should also be borne in mind that Hungary's economy was in the midst of recession during this period) the achievements of the first post-communist government in privatizing state-owned corporate assets and fostering development of the private sector in Hungary were far from paltry. Between December 1992 and December 1993, the private sector's estimated contribution to GDP rose from around 25 per cent to 65 per cent (UN ECE), while its share in employment was estimated at around 53 per cent at the end of 1993 (see also Section 5, below). The momentum and volume of privatization *per se,* following a lethargic start in 1991-92, picked up in 1993 with the introduction of preferential schemes for domestic investors and the launch of the "self-privatization" programme for small to medium firms.[9] The biggest single boost (in terms of revenue and prestige) to privatization in this period was the sale of a 30 per cent stake in the state telecommunications company, Matáv, to an American-German consortium in December 1993 (see section 4 below). The revenues accruing to the two asset management bodies (Table 1) reflect the dynamics of privatization over this period.

Table 1. Privatization revenues of SPA and SHC 1990-1995 (HUF bns)

	1990	1991	1992	1993	1994	1995	1991-95
Cash: $ Hard currencies $ HUF - of which dividends	 0.53 0.14 -	 24.61 5.74 0.93	 40.98 24.92 7.41	 110.67 22.96 5.41	 10.95 35.41 7.8	 412.05 39.52 13.79	 599.79 128.69 35.34
Privatization loans HUF	0	1.01	9.07	21.72	29.27	3.92	64.99
Compensation vouchers	0	0	2.26	14.56	64.20	18.48	99.50
Privatization loans in hard currency	0	0	0	0	16.84	0	16.84
Total	0.67	31.36	77.23	169.91	156.67	473.97	909.81

Source: APV Rt.; Voszka, 1996.

3. Developments under the Horn government, 1994-95

When the new coalition government (composed of the Hungarian Socialist Party, with the Alliance of Free Democrats as its junior partner) took office in summer 1994, its stance on privatization comprised the following principles:

- C acceleration of privatization (without prior restructuring of the enterprises concerned by the state asset management organizations);
- C sale of assets rather than distributive methods (free or on preferential terms) of privatization;
- C increasing the role of enterprise management and independent consultancy companies, as opposed to centrally-managed privatization; and
- C transfer of management of state-owned assets (exercise of ownership rights) to commercial firms rather than state-run organizations.

In addition, the new government envisaged the merger of the SPA and the SHC, and proposed to bring the privatization process under the control of the Finance Ministry. These last two elements attracted immediate criticism; whilst in opposition the coalition parties had argued consistently in favour of restoring parlimentary control of privatization and against the creation of the SHC, which they considered a dangerous concentration of assets, its operations lacking in transparency and, as an organization, potentially vulnerable to politically motivated intervention (Voszka, 1996).

Draft legislation was already in preparation when the new government took office, but progress was delayed by seemingly interminable debate and dispute, not only between the coalition and opposition parties, but also between national and local government, and within the government itself. The trade unions and management representative bodies flexed their still powerful muscles against the perceived threat to their membership of the government's preference for cash sales to outside investors over preferential schemes supporting "insider" privatization (ESOP, MBO, "Leasing", etc.). There was vehement opposition among the ministries as regards the new powers to be assigned to the Finance Ministry as overseer of the privatization process, and each of the sectoral ministries battled hard to institutionalize its role (see Voszka, 1996). Finally, at the end of 1994, parliamentary debate on the 1995 budget took precedence, and the discussion on privatization legislation was postponed till early 1995. In this environment of uncertainty, progress with privatization slowed markedly, calling into question not only the government's ability to reconcile the various interest groups and temper the influence of its ideological allies, the trade unions, but its commitment to privatization as such.

The credibility of the Horn government's commitment to continuing privatization was further undermined by the row over the Prime Minister's personal intervention prohibiting the SPA at the last possible moment from going ahead with the sale of a majority stake in Hungar-Hotels (to American General Hospitality) in January 1995. This affair led to the immediate resignation of privatization commissioner Ferenc Bártha, followed by that of Finance Minister László Békesi at the end of January; this in turn resulted in a succession dispute which very nearly upset the stability of the coalition agreement. The debate on new privatization legislation began at the end of January, but stalled again while the new Finance Minister, Lajos Bokros', radical macroeconomic stabilization plan took shape, and with it a drastic overhaul of the state budget which would significantly influence the focus of privatization policy (e.g. budgeting for privatization revenues of HUF 15 bn). Not all of Bokros' proposals regarding privatization were accepted, however, including that of retaining two separate state asset management institutions, and that concerning scrapping the transfer of state-owned assets to the Social Insurance organizations. On these issues, as well as on the question of assigning the principal role in the supervision of privatization to the Finance Ministry, he was obliged to compromise.

The Privatization Act (Act No.XXXIX of 1995) was finally passed on May 9, 1995, after no fewer than 486 amendments had been debated (Mihályi, 1996), and came into effect the following month. On June 17th the government formally established the new State Privatization and Holding Company (SPHC), which although legally the successor of the SHC, in fact mirrored more closely the SPA's organizational structures (e.g. division into sectoral units), albeit with more centralized decision-making procedures (increased powers of the Director and Board). The shift towards greater bureaucratic control of privatization transactions was reflected also in the emphasis on "individual considerations" (Section 2(2) of the Act), and the scope for case-by-case evaluation of companies' privatization proposals granted to the SPHC under the so-called "simplified privatization" scheme introduced in the Act (see also Section 5 below). At the same time, the Act no longer provides for privatization led by approved independent consultants, the decentralized mechanism known as "self privatization" which operated under the earlier legislation.

The Act reflects substantial compromise (and, according to several observers - e.g. Voszka, 1996; Mihályi, 1996 - a dangerous lack of clarity, even contradiction, on a number of points) by comparison with the government's original stance. While cash sales are emphasized on the one hand, the Act continues to allow considerable leeway for all the earlier preferential schemes supporting employees and small domestic investors (with the exception of the Small Investor Share Purchase Programme). It is the declared objective of the Act to provide for the "most rapid possible sale of state assets to private owners" (Section 1(1)), but few if any mechanisms are provided in the Act to ensure the realization of this objective.

Overall, while the passing of legislation on privatization did little to quell the debate on the underlying issues, which has continued both in the political and in the public domain, analysts and those involved in privatization appear to have reached consensus on one point: that the merger of the SPA and SHC has proved more advantageous than disadvantageous (Mihályi, 1996). Of greatest significance, however, is undoubtedly the fact that the new Act provided the legal framework for the privatization of the strategic sectors, to be discussed in depth in the next section.

4. Privatization and regulation of strategic sectors

Public (state-owned) corporations, notably in the network utilities, where there is some element of natural monopoly,[10] can (and do) function reasonably efficiently in many western economies, given the appropriate legislative and regulatory framework, good governance and competitive environment as regards product markets.[11] None of these were present in former centrally planned economies, or only to a very limited degree. Even if these conditions had been fulfilled, however (and beyond the general consideration that the post-socialist era governments of CEE countries had to make a credible commitment to disengage from political intervention in the management of enterprises), there were several cogent arguments in favour of privatizing the infrastructure industries in the special circumstances of CEE. Ordover, Pittman and Clyde (1994, pp.320-323) provide a useful summary:

- *ability and incentive to raise prices*: elimination of dramatic price distortions from the socialist era (politically sensitive);
- *ability and incentive to raise capital*: infrastructure utilities are capital-intensive industries; the transition economies of CEE, meanwhile, were characterized by a lack of capital (demands on state budget, embryonic capital markets), certainly on the scale required to upgrade and expand run-down, underdeveloped networks and services - especially telecommunications and transport infrastructure (essential for a functioning market economy); in the case of energy (from the 1970s through to 1990 Hungary depended increasingly on imports[12], mainly from the former Soviet Union), the cost of diversifying sources;
- *ability and incentive to utilize an efficient mix of inputs*;
- *adaptability to change in future*.

The main strategic sectors/companies in Hungary are:

- MATAV - telecommunications
- Antenna Hungaria - radio and television broadcasting
- MOL - oil and gas industry
- MVM (and subsidiaries) - electricity generation/distribution

C 5 regional gas supply companies

C OTP, MHB, BB, K&H - commercial/retail banking sector.

4.1 Privatization issues

The strategic sectors were not priority candidates for privatization (with the exception of telecommunications, in view of the sector's significance in economic regeneration and its pressing development needs); most of the companies in these sectors were transferred to the portfolio of the SHC in 1992[13] as assets to be retained at least partially in state ownership in the longer term (in the majority of cases, a stake of 50% + 1 was envisaged), with plans to allocate a further stake to the local municipalities, but not ruling out the possibility of eventally involving an element of private capital. Despite substantial reorganization and cost-cutting in the energy sector companies, modernization efforts stagnated and profits plummeted, principally due to the continued distortions in price structure. The deteriorating macroeconomic situation (external and internal debt, budget deficit) was an additional source of pressure, and it was becoming apparent that there were ever fewer "privatizable" assets remaining in state ownership which would attract substantial foreign investment revenues.

Utilities assets were considered a good investment, but the prospect of rival privatizations, in both western and eastern Europe, placed the government in Hungary under considerable pressure to refocus its policy and accelerate the process of preparing the regulation and privatization of these sectors. Preparations for privatization began in 1993, and although progress seemed to have stalled indefinitely following the general election in spring 1994, the new government finally gave its approval in principle to the partial privatization of the energy utilities (as well as to the second phase of telecoms privatization) in November 1994.[14] There were a number of issues which were of particular significance in determining the most appropriate strategy for the privatization of the strategic sectors:

4.1.1 Appropriate type of investor

In the majority of cases, foreign, strategic investors were preferred (in the case of consortia, the strategic partner(s) had to have a stake and controlling rights equivalent to at least 50%). In addition, potential strategic investors had to fulfil a number of financial and technical criteria to ensure that they had adequate capital and experience to meet the privatization and investment commitments required of them. There were, however, two important exceptions where financial (portfolio) investors were sought: that of the oil and gas conglomerate, MOL, and the National Savings Bank (OTP), the biggest bank in Hungary in terms of assets (31% of total bank assets) and number of branches nationwide, as well as having the largest share (two-thirds) of the retail market.

In the case of MOL, the shift away from seeking a strategic investor occurred after prolonged negotiations; potential investors appeared interested only in some of MOL's operations, while the industry itself lobbied hard to retain its autonomy, reluctant to be subsumed into one of the big multinational oil companies. In the end, 18.5 mn shares with a nominal value of HUF 1,000 were sold in autumn 1995 via private placement (on the US, Luxemburg and London stock markets) to foreign institutional investors; at the same time, 5.4 mn shares were sold to MOL employees and 492,000 to management on preferential terms. In December 1995 a further 3.5 mn shares were sold on the domestic stock market.

As regards OTP, the debate was even more sharply polarized (see Mihályi, 1996; Várhegyi, 1996); finally, in February 1995, it was decided that OTP should remain principally a Hungarian-owned bank; its position (in terms of capital and market share) was sufficiently stable to do without the help of a strategic investor, and yet prove attractive to portfolio investors. Accordingly, 20% of OTP's shares were sold by private placement to foreign institutional investors; 20% was transferred to the two Social Insurance organizations, 5% was sold to employees and 8% via public offering on the domestic stock market. These two transactions alone doubled the capitalization of the Budapest Stock Exchange.

4.1.2. Whether to sell a majority or minority stake

In cases where a strategic investor was involved, it was clear that a controlling interest would have to be offered. However, plans to reduce the state holding to a minority in strategic companies met with vociferous opposition both in parliament and beyond. The question was finally resolved in summer 1995 by an amendment to the Privatization Act (which had only just been passed) introducing the concept of the "golden share", which the state would retain in the case of the 5 regional gas supply companies, 8 electricity generation companies, 6 electricity transmission companies and the national electricity grid (OVIT). Economists have evinced some scepticism regarding the usefulness of the golden share clause. Given that the state, via the SPHC, is able to use its bargaining position to influence the terms of the concession contracts and operating licences granted to the companies investing in the utilities, the actual need for a golden share in the Hungarian case appears somewhat overstated.[15]

4.1.3. Whether to sell whole companies or separate parts

Most of the utilities had undergone substantial reorganization since 1990, for the most part converting the vertically-integrated monoliths created in the late 1950s/early 1960s into multi-enterprise structures composed of a number of joint-stock companies. The issue arose again, however, in the context of privatization - with particular force in the case of the national monopoly electric utility, MVM, and its subsidiaries, the national network operator (OVIT), the power stations, electricity supply companies and maintenance companies. Plans for the partial privatization of MVM and its subsidiaries were already well under way in accordance with the original concept outlined in the government resolution of November 1994;[16] pressure from the then Minister for Industry and Trade, László Pál (summer 1995), backed by the trade unions, to keep the companies in majority state ownership, stalled the process and finally cost Pál his ministerial portfolio. Finally, plans were modified and it was decided to sell a minority stake (but close to 50%) in the power generators and distributors, giving investors the option of converting to a majority stakeholding in 1997.

In the case of MOL, a general consensus emerged on the benefits of keeping MOL as an integrated, unitary company following its earlier reorganization (1991), when the 5 regional gas supply companies were separated from MOL's predecessor, the oil and gas conglomerate

OKGT.[17] The question here was rather whether to merge the company with Mineralimpex, and thus integrate Hungary's gas import/export trade (principally the former Soviet supply contracts) into the company profile. Mineralimpex was finally transferred to MOL in May 1995, increasing the company's registered capital from HUF 97.6 bn to 98.4 bn. It is recognized, however, that MOL's monopoly position as sole producer and wholesaler of gas, as well as owner of the transmission network, will have to be reviewed in the coming years in the light of EU plans for the future liberalization of European energy markets.[18]

4.1.4. Whether the sale should include equity raising

The socialist/liberal coalition government's privatization strategy placed considerable emphasis on raising the companies' equity. However, some of the arguments voiced in relation to the concept were rather wooly, not to say misleading, e.g., in the case of the energy utilities, that it would reduce the pressure to raise prices.[19] On the other hand, in the case of industries facing massive development commitments (e.g. telecommunications), capital raising can avert major solvency problems. Such was the case in the first phase of Matáv's privatization. Similar considerations were at work in the proposals for Antenna Hungaria, and in the case of the power generators (likewise the subject of intensive development programmes), acquisition of a majority stake was made conditional on capital raising.

4.1.5. Timing

In the case of the strategic sectors, successful timing of privatization has more to do with the regulatory environment than the financial indicators of the companies concerned. The SPA issued tenders for the privatization of minority stakes in the regional gas companies as early as April 1992, and one year later launched a similar initiative for the electricity distributors. The tenders were withdrawn, however, since the bids received proved unacceptably low (equivalent to between 6-60% of the nominal value of the shares), underscoring the significance for potential strategic investors of legislative and regulatory conditions being clarified prior to privatization.[20]

Table 2. Privatization of the energy utilities (main indicators)

	Equity (HUF bns)	Registered capital (HUF bns)	Stake sold (%)	Price (HUF bns)	Price (USD mns)	Share price (relative to registered	Share price (relative to equity)	Investor

						capital)		
MOL Rt	263.59	97.56	18.96	20.86		112.76	41.74	150 institutional investors [a]
Gas distributors:								
DDGÁZ	7.35	5.09	50+1	7.0	52	275.05	190.48	Ruhrgas/ VEW Energie
DÉGÁZ	15.31	12.45	50+1	12.5	92	200.80	163.29	Gas de France
ÉGÁZ	7.04	4.73	50+1	10.4	77	439.75	295.45	Gas de France
KÖGÁZ	10.55	6.37	50+1	9.1	67.2	285.71	172.51	Bayernwerk/EVN
TIGÁZ	24.41	15.94	50+1	23.4	171.8	293.60	191.72	Italgas/ SNAM
Total gas	64.66	44.58	50+1	62.4	460	279.95	193.01	
Electric utilities:[b]								
ELMÜ	61	62	n.a.	49.5		174.9	n.a.	RWE Energie/ EV Schwaben
TITÁSZ	34.16	34.16	49.23	17.90		106.44	106.44	ISAR Amperwerke
ÉMÁSZ	30.50	30.50	48.81	22.47		150.91	150.91	RWE Energie/ EV Schwaben
DÉMÁSZ	39	37.03	47.98	21.23		119.53	113.47	EDF International
ÉDÁSZ	51	46.88	47.55	26.99		121.07	111.30	EDF Internatinoal
DÉDÁSZ	31	29.80	47.25	14.80		105.09	101.02	Bayernwerk
Dunamenti Power Stn.[c]	36	33.54	48.76	19.33		118.18	110.14	Powerfin/ Tractebel
Mátrai Power Stn.[c]	36	34.25	38.09	10.14		77.74	73.96	RWE Energie/ EV Schwaben
Total electric	318.66	308.16	46.81	181.91		126.11	121.96	

Notes:
a) Mainly US and UK investment funds.
b) The successful bidders also have the right to convert their stake to a majority one after two years (i.e. in 1997).
c) 7 power stations were put up for sale (the eighth, the nuclear power station at Paks, was excluded), but the bids received in all but the above two cases were judged unacceptable by the SPHC.
Source: Mihályi (1996); Voszka (1996), Heti Világgazdaság 1996/5, February 3.

4.2 Regulatory issues

4.2.1. The legislative and regulatory environment[21]

The Act on Concessions (Act No.XVI of 1991) provided the basic framework for the granting of concessions, mainly by public tender and subject to payment of a fee, to developers/providers of public infrastructure services including highways, road and rail transport services, telecommunications, and extending to mining activities (exploration and exploitation) and the transmission via pipelines of oil and gas. Under the Act, concessions are granted for a specified period (with a maximum of 35 years) and may only be extended once without issuing a new public tender, and then only for half of the originally specified period.

Telecommunications and frequency management legislation were passed in 1993, and the tariff regime overhauled in line with international practice with effect from January 1994 (see case study below).

The Act on Mining (Act No.XLVIII of 1993) is of considerable significance in the context of energy regulation and privatization. It makes detailed provision for the granting of concessions for mining and related activities, including exploitation of domestic oil and gas fields, and for the distribution and storage of hydrocarbons. Of special significance for the gas supply industry is the provision of open access to the natural gas transmission pipelines (owned by MOL) where there is extra capacity (this applies only to natural gas produced in Hungary), thus preparing the way for the de-monopolization and introduction of competition in gas supply.

By far the most important pieces of legislation as regards regulation of the energy sector are the Act on Gas Supply and the Act on the Generation and Distribution of Electrical Energy (Acts Nos.XLI and XLVIII of 1994), whose scope includes not only regulation of the transmission, supply and sale of gas and electricity, and the obligation to meet reasonable demand for a supply, but also safety provisions and provision for environmental and consumer protection. The Gas Act also makes provision for establishing the Hungarian Energy Office (MEH), a government agency under the supervision of the Ministry of Industry and Trade, and defines its regulatory functions, which include the issue of licences, e.g. for the supply of gas.[22] MEH also has the power (both under the Act and in the terms of the operating licences) to inspect installations (including consumer appliances) and their operation and maintenance, and may require licenced supply companies to seek authorization in the case of certain commercial decisions which could affect their ability to supply (e.g. mergers, demergers, reduction of equity and "sale of a significant stake").

4.2.2. Price regulation

C In the case of oil and oil derivatives, government price controls were removed with effect from 1991, since when both retail and wholesale prices have been market-driven. Ex-refinery prices are set by MOL in accordance with world market levels to compete with imports. Price controls for coal, coal-related products and Propane-Butane gas were also removed from March 1992.

C Until December 31, 1996, the maximum official prices for natural gas are regulated by the Pricing Act (Act No. LXXXVII of 1990), with a phased increase beginning in 1995,[23] in accordance with the rules for price formulation and application established by MEH, as stipulated in the Gas Act.[24] Pricing from 1997 is subject to a government resolution (Resolution No. 1075/1995 (VIII.4)), which stipulates that both wholesale and retail prices must fully reflect justified operating costs and investments (including environmental commitments), and allow for an 8 per cent return on equity to ensure operational continuity. Prices are to be set by the Ministry of Industry and Trade, on the recommendation of the MEH, in accordance with an escalation formula (indexed to CPI) annexed to the resolution.

C As in the case of gas, increases in electricity prices were introduced in three stages from September 1, 1995;[25] under the Electricity Act, charges for electricity from 1997 must contain justified costs and allow for an 8 per cent return on equity. Charges for district heating (including hot water and steam to industrial consumers), following a 1995 amendment to the Pricing Act, are determined by the Ministry for Industry and Trade in consultation with MVM (in the case of power stations owned by MVM), on the basis of actual costs, and by the Municipalities in the case of district heating companies. (Comprehensive legislation and regulation of heat supply is pending.)

The regulatory system in Hungary is undoubtedly still in its infancy, and analysts are quick to point to actual or potential shortcomings. While legal loopholes may present problems of interpretation, however, and it may yet be some time before the institutions monitoring the operations of the regulated utilities develop the mechanisms for smooth and clear communication between the various groups whose interests they are designed to protect, such problems do not necessarily represent an insurmountable risk to investors in the utilities, while consumers in Hungary and other CEE countries have yet to develop adequate representative mechanisms. A far more important question, certainly as far as the investors (and the companies themselves) are concerned, is the credibility of the government's commitment to maintaining an "arm's-length" relationship with the regulatory framework it has put in place.

Incidents such as the Prime Minister's personal intervention in the privatization of the Hungar-Hotels chain in January 1995, effectively annulling the transaction, brought considerable scepticism from within Hungary and abroad concerning the Hungarian government's commitment to continued depoliticization of the economic sphere, and fears that party-political forces still retained the upper hand in the state apparatus. On August 22, 1996 the government announced its decision - over the head of Industry Minister, Imre Dunai (who immediately tendered his resignation) - to postpone the third stage of energy price increases (scheduled for October 1, 1996) till January 1997, despite its legal obligation and pledge to investors to implement the increases. Again, confidence in the current government has been undermined, and share prices have been dealt a severe blow (shares in MOL fell by 9 per cent within one day on the Budapest and London Stock Exchanges, trading in MOL shares was suspended for a day, and trading on OTC markets of shares in the regional electric utilities came to a standstill). In addition to the potential losses to the investors,[26] such incidents call into question the stability of the regulatory system and are likely to jeopardize further privatization of the strategic sectors in particular (and thus also the revenues to the state).

4.3. Case study: Privatization and regulation of telecommunications

Reform and privatization of telecommunications was given priority over that of other utilities in Hungary and in most of the transition economies in CEE for several reasons:

- C the extreme backwardness of the existing network and services,[27] starved of investment under socialism (due to emphasis on "material" production sectors; ideological control of information), presented a serious **barrier to economic regeneration**, especially to the development of the private sector, to competitive foreign trade and thus to prospects of integration into the world economy. It was also the major technical impediment to the development of other services and institutions essential to a market economy, e.g. banking and financial services, business information services, data processing, as well as to the modernization of the state administration.
- C the **scale of investment** (much of it, moreover, long-term, sunk investment) required to extend and modernize the sector to bring Hungary's telecoms network up to the average 1990 EU level (38% penetration) by the end of the century,[28] was beyond the scope of domestic investors and of the hard-pressed central budget. Domestic investment resources had shrunk due to the fall in GDP (-3.5% in 1990; -11.9% in 1991) and to the imposition of monetary and fiscal controls in order to stabilize the economy and curb inflation; Hungary was both internally and externally indebted, and the transition placed extra burdens on the budget (e.g. unemployment), further constraining investment; due to their high subsidy content, rapid liberalization of charges for telecommunications services in order to raise revenue for investment was politically infeasible within the state sector.
- C investment in telecommunications development has significant externality effects (especially for an economy in transition) which made it an **objective of economic regeneration** in itself: creation of new employment (absorption of unemployed labour, reducing welfare burden); it is a growth industry, attractive to investors and resilient to recession (inward investment, forex revenues); technology transfer, with its attendant benefits; increasing the value of human capital (technical, management skills); multiplier effects (creation of new service industries, businesses).

The Hungarian Telecommunications Company (Matáv), the national telecoms provider, among the five largest companies in Hungary in terms of capital and turnover, was founded in 1990 when the Hungarian Post Office was divided up, separating its constituent operations, postal services, telecommunications and broadcasting. Regulation of telecommunications was transferred to the Ministry for Transport, Telecommunications and Water Management (MTTW). Corporatization of Matáv was completed in July 1991, when the company was registered as a joint-stock company wholly owned by the state (which exercized its ownership rights through the SPA, until the SHC was established in late 1992 to manage strategic assets of the state). As the groundwork was being laid for a partial privatization of Matáv involving a strategic foreign investor, the company embarked on a massive programme of network development, raising funds in the form of development loans from multilateral organizations such as the World Bank and the EBRD, commercial bond issues, incentive schemes for potential subscribers, and - in an innovative move - launched its own (joint venture) investment company, Investel.

Partial liberalization of its pricing regime, including consumer tariffs, in 1991, increased revenues and opened further external credit lines, as well as enhancing the sector's attractiveness to foreign investors poised to enter the potentially lucrative CEE telecommunications markets as soon as the legislative and regulatory environment became more transparent. Earlier liberalization of other segments of the market, e.g. equipment manufacture, had led companies such as Siemens and Ericsson into the arena from 1990 with major joint ventures, providing much of the hardware required for the first phase of modernization, the installation of a new digital overlay backbone network and digitalization of exchanges (despite COCOM restrictions, which were only eased in February 1992). By 1993, significant progress had been made; over half a million new lines had been installed and waiting times for potential subscribers had been halved in many areas (see Table 3). Matáv reorganized and decentralized its operations, setting up a number of subsidiaries and joint ventures to carry out diverse activities ranging from network construction to international trading, and in summer 1991 launched Westel, the first (analogue) mobile telephone service in CEE, in a joint venture with US West.

Table ***3. Data on Telecommunications in Hungary (1991-94)***

	1991	**1992**	**1993**	**1994**
Main lines	1,128,129	1,291,133	1,497,577	1,731,502
Main lines per 100 inhabitants	10.92	12.52	14.57	17.3
Public payphones	26,725	28,321	30,631	33,700
Card phones	300	1,218	8,500	-
Exchanges automatic (%) - of which digital (%)	1,710 93.2[a] 7.4[a]	1,680 95.2 16.5	1,735 96.5 33.0	1,829 - 47.0[b]
Telefax stations	14,580	24,721	29,388	-
Telex stations	14,213	13,296	11,664	-
Waiting list (potential subscribers)	657,796	753,079	771,873	-

Notes:

a. 1990

b. 1995; Business Central Europe (1995), p.43.

Sources: Matáv Rt.; UK Government OTS (1994); Hunya (1995).

While network development and the diversification of value-added services proceeded at a remarkable pace, progress with legislation on telecommunications and resolving regulatory uncertainties was much slower. The Telecommunications Act was passed in November, 1992, but did not come into force until July 1993, following the passage of companion legislation on frequency management. The Act was accompanied by a policy document setting out the government's strategy for development of the various segments of the telecommunications market, defining policy principles on the granting of concessions for the provision of telecommunications services, outlining the regulatory regime and plans concerning Matáv's privatization.

These two documents represented something of a compromise on the key issue of Matáv's monopoly as the national services provider. Initial drafts, envisaging the introduction of competition only in value-added services, but retaining exclusive use of the base network (on grounds of natural monopoly) showed the influence of the telecommunications industry. Months of debate moderated the policy finally adopted; liberalization was envisaged for an extensive range of telecommunications services and, significantly, competition was to be introduced in the regional telephone markets. On the other hand, Matáv would retain its monopoly over the national network (on the grounds of its "obligation to supply" and to prevent "cherry-picking" in the development and provision of services); its monopoly in the international and domestic long-distance market would also be retained until 1999, in order to secure (via continued cross-financing) the revenues necessary for the "stable" completion of network modernization and development, and enhance the company's eventual privatization prospects (and thereby also the likely revenue to the treasury from privatization). Although the abolition of Matáv's monopoly in the provision of local services was a significant step (and unique in the region),[29] and the gradual phasing out of its monopoly in other segments of the market was in accord with EU policy concerning telecommunications monopolies in its own member states, the dominant position of Matáv remained secure, especially given that many value-added services also rely on access to the base network.

Under the Telecommunications Act, the market is divided as follows:

- **C** **services subject to concession agreements** (under the provisions of the Act on Concessions): these consist principally of those services which the state has an obligation to supply, e.g., public telephony services, public mobile telecommunications services, public national paging systems, and both national and regional television/radio broadcasting. The Telecommunications Act stipulated that, from April 30, 1994, public telephony services could only be provided by concession-holders. Local concessions were to be put out to tender if a majority (50%) in the local municipality so requested, and Matáv would be allowed to bid on the same terms as other would-be service providers.
- **C** **services subect to licence**: e.g. public switched data transmission, cable television.
- C **services not requiring authorization:** e.g., proprietary, private or closed group networks within the premises of any organization or business.

There is no unitary regulatory authority; instead, different functions are assigned as follows:

- C the **Communications Supervisory Authority**, with regional offices throughout the country, holds responsibility for issuing licences for the provision of telecommunications services;

- C the **Telecommunications Conciliation Forum** has as its principal function to "protect the public interest", liaising between national and local government bodies, industry representatives and consumers and arbitrating in case of disputes between them;[30]
- C the **Ministry of Transport, Telecommunications and Water Management (MTTW)**, to which the other two bodies are accountable, has overall regulatory responsibility, notably for formulating and implementing policy and regulating prices.

A radical and necessary overhaul of price regulation was carried out, and a new tariff regime was introduced with effect from January 1, 1994, replacing administratively set (by ministerial decree) maximum charges for individual services with a price-capping system in the case of most tariffs. Not unlike the system in operation in the UK, the cap applies to the rate of increase in total revenue earned from a group of services, but in Hungary it is indexed to producer prices (PPI) rather than consumer prices (the CPI, as in the UK). The regime is designed with the intention of gradually eliminating the long-standing price distortions resulting from cross-subsidization and bringing charges, especially for local calls, into line with costs by the end of the decade. In real terms, the cap (shown in Table 4 below) is expected to mean an annual price increase of 15-20 per cent in the case of local and zone I calls, and a reduction of approxiately 10 per cent per annum in charges for domestic long-distance (zones II and III) and international calls.

Potential investors appeared undeterred by the delay in implementing the new price regulation mechanism and establishing the regulatory institutions. 14 major telecommunications companies (or consortia) submitted bids in August 1993,[31] when the tender was issued for the privatization of a significant minority stake (at least 30%) in Matáv, along with a concession for the provision of public international and domestic long-distance services and local services in 29 areas (see endnote 29). The duration of the concession was to be 25 years, renewable for a further 12.5 years, with a clause granting 8 years' exclusivity and committing the concession-holder to a development plan including a minimum 15.5 per cent annual increase in the number of telephone lines and elimination of the waiting list by 1997. Four bidders were short-listed to participate in the second round, the outcome of which was announced in December 1993: the German-US consortium, MagyarCom (comprising Deutsche Telekom and Ameritech) had acquired a 30.2 per cent stake, along with operational and financial control of Matáv, for the sum of USD 875 mn, surpassing the expectations of the most optimistic analysts.[32] USD 400 mn was to be used to raise the company's equity; USD 133.25 in concession fees was to be paid to the Ministry (and ultimately into the Telecommunications Fund); USD 6.5 mn covered the privatization consultants' fees, while the remaining USD 335.25 mn was paid to the SHC in exchange for Matáv shares.

The second phase of Matáv's privatization was beset by delays and uncertainties related to the protracted debate on privatization policy and legislation under the new socialist/liberal government which was elected into office in summer 1994. A decision in principle was announced at the end of 1994 to reduce the stake to be held long-term in state ownership to 25% + 1 vote. Regarding the nature and timing of the sale of a second tranche of shares, a number of issues arose which focused sharply the interests of the government (via the State Privatization and Holding Company (SPHC), which took over the functions of the SPA and SHC following the passage of the new Privatization Act in summer 1995) and those of the incumbent stakeholder, MagyarCom.

First, there was the question of whether to target the sale at portfolio or strategic investors; since seeking a strategic investor other than MagyarCom itself would have been out of the question, the debate revolved around whether the sale should take place by means of public offering and/or stock market flotation, or by inviting MagyarCom to convert its minority stake to a majority one. MagyarCom clearly had an interest in increasing its stake to at least 50% + 1, and there were strong arguments for postponing any share issue or flotation until the company was in a stronger financial position.[33]

On the other hand, the position of SPHC reflected the government's need for privatization revenue - if possible by the end of 1995 - if the budget deficit was to be kept under control and the targeted figure for revenues from privatization (HUF 150 bn) for 1995 was to be met. In effect, the state asset management company increasingly aligned itself with Matáv/MagyarCom representatives in favour of the more rapid and straightforward option: allowing MagyarCom to increase its stake. However, the SPHC was keen to sell the maximum possible stake;

MagyarCom had to be persuaded, since the acquisition of more than 50% + 1 voting share would not significantly increase its control over the company (Mihályi 1996). Finally, in late December 1995, it was announced that MagyarCom was to purchase a further 37 per cent stake in Matáv for the sum of USD 852 mn, thus giving it a total stake of just over 67 per cent.[34]

Table 4. Telephone tariff regulatory regime

Tariff	Pre-1994	Post-1994
Connection	administratively fixed charge	administratively set maximum charge
Repair	based on actual cost	unrestricted
Line rental	administratively set maximum charge	price cap
Local calls	administratively set maximum charge	price cap (PPI+7%)
Domestic long-distance calls - zone I	administratively set maximum charge	price cap (PPI+7%)
Domestic long-distance calls - zones II and III	administratively set maximum charge	price cap (PPI-4%)
International calls	unrestricted	price cap (PPI-4%)

Source: MTTW; Heti Világgazdaság, 1993/32, August 7, p.45.

5. Privatization and growth of the private sector in Hungary

5.1. Competition policy[35]

The importance of competition policy as part of the institutional framework for a market-type economy, reinforcing privatization and the formation of new private businesses, has long been recognized in Hungary. The current Act on competition policy has been in force, virtually without amendment, for 5 years, but a new draft law was laid before parliament in June 1996. One major change will be the widening of the scope of the act to cover not only businesses and business activities, but any person or organization (e.g. professional associations) whose actions are deemed to undermine competition. A company's behaviour abroad can also be taken into account under the amended law, in cases where the company's activities abroad will have an effect on competition in Hungary. Consumers will also be given more extensive protection from misleading marketing practices (which accounted for the largest number of fines against companies in the past five years). Company mergers - expected to increase in numbers in Hungary over the next few years - will also come under closer supervision in future.

The most significant changes to be brought about by the new Act are listed below, and then discussed:

C broader range of legal and natural persons falling within the scope of the Act;

C application of the general clause (forbidding unfair market practices) will become a metter for the courts instead of the Competition Office;

C regulations governing practices which mislead the consumer are modified and extended;

C prohibition of "vertical cartels" between market agents not in competition with each other;

C removal of prohibition of cartels formed between companies under the same ownership (i.e. not independent);

C government may grant exemptions from cartel prohibition at its discretion, including overriding an earlier decision by the Competition Office;

C definition of types of merger requiring authorization has been broadened (i.e. acquisition of controlling rights, not only structural fusion);

- C ceiling on market concentration of companies to be determined on the basis of revenue from sales (set at HUF 10 bn), not market share;
- C a market share of over 30 per cent will not be assumed *per se* to imply market domination;
- C the Competition office will have greater control over decisions to take legal action (via the Competition Council) in cases of alleged violation of competition law or unfair practice;
- C decisions to initiate proceedings under the law must be made public by the Competition Office;
- C the proceedings of the Competition Council (court) are to be public;
- C the Competition Council may declare its judgement (including payment of any fines) to be effective immediately;
- C interest to be charged at twice the current central bank rate on any overdue fines;
- C where a decision of the Competition Office is found to be in breach of the law, the CO will pay any fine, plus damages incurred, with interest at the same rate as above.

5.2. Institutions managing privatization

The 1996 budget provided for the establishing of the Treasury Property Directorate (Kincstári Vagyoni Igazgatóság), under the direct supervision of the Finance Ministry. However, the precise role and functions of this body remain undefined - especially with regard to the "division of labour" between this and the State Privatization and Holding Company (APVRt). At some time in the future, a decision must be reached with regard to the future of the APVRt. If privatization of state-owned corporate assets is completed in 1997 (as planned), will the APVRt be disbanded? What form of institutional management will be put in place to look after the shares remaining in state ownership in the longer term (e.g. 25% stake in MOL and in the electricity companies)? Some observers think it possible - even likely - that a third institution - the investment arm of the Hungarian Investment and Development Bank (there are plans to split the bank in two) - will be given charge of this task. Others do not rule out the possibility that - depending on the political environment - responsibility will revert to the relevant ministries.

Table 5 shows how the portfolio of state asset management companies changed between 1990 and 1995. It can be seen that at the end of 1995 Hungary only had 12 completely state-owned companies, but there were still several hundred companies with majority state ownership. Table 6 shows the flows of income and expenditure generated by the privatization and other transactions of the asset management companies. Clearly, 1995 was a very successful year for Hungary's privatization, as we discuss more fully in the next sub-section.

Table 5. Changes in the portfolio of the state asset management bodies (to 31.12.1995)

State-owned enterprises As of January 1, 1990	**Number** 1,857
Changes (from January 1, 1990)	
? Transferred to other asset management organization ? In liquidation ? Dissolved ? Closed down ? Incorporated	86 324 122 15 1298
State-owned enterprises as of 31 December 1995	12
Companies	1658
? Established via incorporation	1298
? Founded or acquired ? Transferred from other asset management bodies	330 30
Changes	
? Transferred to other asset management organizations ? In liquidation ? Dissolved ? Closed down ? 100% privatized (sold) ? Under asset management	61 104 32 20 771 9
Current number of companies*	661
of which ? in majority state ownership ? in minority state ownership	363 298

Source: ÁPV Rt., Mihályi, 1996.

Note: * The state retains a long-term stake in 88 companies.

Table 6. Income and expenditure of the state asset management institutions 1990-1995 (in HUF bns)

EXPENDITURE	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**Total**
Directly related to privat-ization and asset manage-ment (incl. operational costs)	-	1.14	6.16	7.56	25.26	14.78	54.90
Payments to municipalities and companies required by legal provisions	-	2.29	4.30	3.42	6.04	6.07	22.12
Payments and reserves related to guarantees	-	-	5.78	7.79	7.01	3.65	24.23
Payments related to reorganization of assets (companies); investments in preparation for privatization	-	-	8.70	49.53	8.03	17.38	83.64
Payments to budget (total) - of which:	0.51	22.37	51.51	57.45	151.67	176.37	459.88
$ direct payments to budget	0.51	9.36	24.53	2.61	39.57	150.00	226.58
$ contributions to special government funds	-	-	4.50	7.22	17.95	0.24	29.91
$ payments in respect of state commitments	-	-	22.48	47.62	94.15	20.57	197.83
$ dividend payments	-	-	-	-	-	5.56	5.56
Other	-	-	-	-	-	23.69	23.69
TOTAL*	**0.51**	**25.80**	**76.45**	**125.75**	**198.01**	**241.94**	**668.46**
INCOME							
Convertible currencies	0.53	24.61	40.98	110.67	10.95	412.05	599.79
Forints	0.14	5.74	24.92	22.96	35.41	39.52	128.69
- of which income in respect of assets	-	0.93	7.41	5.41	7.8	13.79	35.34
Credit	0	1.01	9.07	21.72	29.27	3.92	64.99
Compensation vouchers	0	0	2.26	14.56	64.2	18.48	99.50
Convertible currency credit	0	0	0	0	16.84	-	16.84
TOTAL	**0.67**	**31.36**	**77.23**	**169.91**	**156.67**	**473.97**	**909.81**

* In January 1996, HUF 192 bn was paid to the budget from the surplus privatization revenue in 1995.

Source: APVRt.; Heti Világgazdaság, June 8 1996, p.100.

5.3. Progress with privatization

1995 set a record for the privatization of state-owned assets in Hungary; in terms of book value, HUF 481 bn state-owned assets were transferred to private owners, 20 per cent more than in the previous 5 years taken together. Cash revenues were also correspondingly high, at HUF 438 bn (60% higher than the total so far). Thus despite a slow start, numerous disputes and the apparent stagnation of privatization initiatives in the first three-quarters of the year, November and December brought some real successes. However, the 15 headline-stealing strategic sector transactions deflected attention from other developments in the privatization process. Other important transactions included the completion of the privatization of Hungary's pharmaceutical firms: Egis, Biogal, Chinoin, Richter and Humán, to a mixture of institutional and strategic investors, bringing revenues totalling more than HUF 18 bn. A number of these large transactions (though fewer in total than in the previous year), as well as the sale of MOL and OTP shares took place on the Budapest Stock Exchange, greatly boosting its capitalization. Towards the end of 1995, the long-delayed privatization of Budapest Bank (an earlier contender, Credit Suisse, had withdrawn in March) was successfully resolved with the sale of a 60 per cent stake to General Electric Capital Services for the sum of nearly USD 90 mn.[36]

Sales of small and medium-sized firms, on the other hand, totalled only 119 in 1995, compared with 228 in 1994 and 230 in 1993.[37] The so-called pre-privatization, affecting retail, catering and small service establishments, which was launched in 1990[38] as one of the earliest privatization initiatives, had not yet reached completion at the end of 1995. Some 350-400 cases still await resolution (out of a total of approximately 10,700), the long delay in most cases being due to legal disputes related to past anomalies in practice regarding land registration and leasehold rights. Total revenues to the state from pre-privatization are in the region of HUF 20 bn, so the sale of the remaining outlets is unlikely to swell the state coffers to any great extent.

The "simplified privatization" scheme[39] for small and medium businesses (with assets of less than HUF 600 mn and fewer than 500 employees), was initiated by the socialist/liberal government in 1995 (under the new Privatization Act) in the interests of speeding up privatization and increasing cash revenues. A crucial distinction between this scheme, which aimed to include 300-400 firms, with the minimum involvement of the SPHC, and the earlier "self-privatization", was that it was managed largely by the senior management of the firms themselves. Firms were expected to recommend a sale price (set on the basis of prescribed criteria), which was then approved or amended by a specialist committee set up for the purpose by the SPHC, following which a batch of firms would be listed and memoranda issued. If the firm failed to attract a purchaser in the first round, the task of privatizing would fall to the management. As of December 1995, out of 73 firms advertised, 37 firms were sold, principally to Hungarian investors, using this technique, while 34 were unsuccessful. A second, and much larger batch of firms was expected to be announced late in 1995, but was delayed until March 1996 - and then only included 48 companies. Among the reasons for the delay, analysts cite legal problems, but also the fact that the need for a case-by-case decision by the SPHC "expert" committee on the minimum asking price for individual firms, has in effect made the procedure more bureaucratic than was intended (Voszka, 1996).

HUF 18.5 bn worth of assets were exchanged in 1995 for compensation vouchers with a nominal value of HUF 10.6 bn.[40] Between 1991 and 1995 vouchers with a total nominal value of HUF 70 bn were accepted by the state asset management bodies in payment for shares (34%) or assets sold via tender or auction (64%). Prospects of absorbing the compensation vouchers still in circulation or yet to be issued (the total estimated nominal value is HUF 81 bn), look increasingly difficult, given the greatly reduced number of privatizable assets remaining and the state's as yet only partially fulfilled commitment to transfer substantial assets to the Social Insurance organizations.[41] This was reflected in the decision, announced in March 1995, to permit voucher holders to convert their entitlement into a life pension.

Contraction of the state sector, vitally important to the relative expansion of the private sector, has been substantial in Hungary, although it is still far from completion. Hungary has remained an attractive destination for foreign investment; with total inflows of almost USD 13 bn up to the end of 1995, Hungary alone accounts for nearly half of total FDI in the CEE region. While around USD 5 bn of this was related to privatization of state-owned assets, an even larger share (USD 8 bn) of total foreign investment went into greenfield projects. The US and Germany are the leading investors in Hungary, both in privatization (see Table 7) and overall, with total investments (to end-1995) of USD 5.2 bn and USD 4 bn respectively. According to Ministry of Industry and Trade figures, foreign-owned and joint venture companies (which total around 25,000), are estimated to account for around 25 per cent of privately-owned entrepreneurial assets,[42] and produce 70 per cent of Hungary's export income.

The MIT puts the share of the private sector as a whole in GDP at around 60 per cent (end-1995; UN/ECE survey estimates give a higher figure (70%, end-1994[43]). 60 per cent of Hungary's banking sector is now estimated to be in private hands (Voszka, 1996). Estimates from the MIT on the weight of the private sector involvement in various industries in 1995 include: trade (90%), construction (75-80%), textiles (75%, with 25% foreign capital), paper industry (60%, including 50% foreign involvement), and printing (55%).[44]

Table 7. Foreign investment in privatization, by country (totals from 1990 to December 1995 at market prices)

Country	**No. of companies**	**HUF bns**	**Percentage of total**
Germany	96	270.75	36.74
USA	34	143.00	19.40
France	41	102.00	13.84
Austria	112	46.75	6.34
Belgium	9	33.93	4.60
Italy	22	27.28	3.70
UK	33	19.64	2.67
Netherlands	14	19.45	2.64
CIS	16	10.45	1.42
Sweden	11	10.04	1.36

Switzerland	16	7.86	1.07
Other $ of which international public offerings	47 19	45.80 40.18	6.21 5.45
TOTAL	451	736.95	100.00

Note: Table does not include greenfield investment.

Source: ÁPV Rt., Mihályi, 1996.

Finally, it is interesting to note that in early September 1996, Tamás Suchmann (formerly minister without portfolio responsible for privatization) was appointed as the new Minister for Industry and Trade. MIT will now assume responsibility for privatisation and the SHPC will also come under MIT control.

6. Conclusions

Hungary's privatisation made a slow start and then accelerated dramatically in 1995 as a range of legal and political issues were resolved, many public utility companies were sold off, and many other components of the privatisation programme bore fruit. In the early months of the present government's life there were serious doubts about Hungary's commitment to privatisation and, correspondingly, there was notably slow progress with new legislation. It also proved unexpectedly difficult and contentious to settle the terms of the merger between the SPA and the SAMC to form the SHPC. Once resolved, rapid progress became possible.

However, it is also important to refer to important financial constraints, both internally, from the Ministry of Finance, and externally from the IMF (among others) which almost certainly contributed greatly to focusing the government's mind and hence allowing the recent progress to be achieved.

It is unlikely that progress with privatisation in 1996 and beyond can be as rapid as in the recent past, partly because there are simply fewer firms left to privatise, and in particular relatively few of the attractive utility companies that did so well in 1995. Moreover, many of the firms still in complete or partial state ownership are in poor economic shape and urgently need either drastic (and presumably expensive!) restructuring, or closure. Either of these options raises difficult and so far unresolved issues about how to pay for restructuring, and how to keep down the social costs of major closures. Hungary's earlier policy of getting on with privatisation and leaving it to new owners to manage restructuring - the new owners paying the necessary costs and also keeping the social consequences of their decisions somewhat removed from government - might simply be unworkable for many of the remaining firms. But no new strategy is yet in sight.

It is possible that the latest shift of privatisation responsibility to the Ministry of Industry and Trade (see end of previous section), including responsibility for the SHPC, might provide the right institutional background for a more "hands on" approach to restructuring. That remains to be seen.

As far as the public utilities are concerned, a great deal of progress with privatisation has been achieved after a somewhat hesitant and uncertain start. For the energy sector and for telecommunications, regulatory bodies have been established to govern pricing policy, various licensing issues, access to networks, investment policy, and related issues, though unlike in the UK the regulators are quite closely associated with the relevant sector ministries. The main issue for regulation has not been the precise details of this or that specific measure (though many questions could be asked about that), but whether the Hungarians would succeed in establishing a regulatory framework that commanded the respect and confidence of the firms being regulated, the population in general, and the government. Unfortunately, as we have seen, the attempt to establish regulation that would function at "arms length" from the government has not yet succeeded, and episodes of undesirable government intervention have been very damaging for regulatory credibility. Even worse, such episodes not only upset the stock market and reduce prices of existing privatised public utility shares (hopefully only temporarily), but the resulting regulatory uncertainty probably serves to lower the price at which subsequent public utility sales will be feasible. There could therefore be a high price to pay for at best very modest gains from the intervention.

Finally, Hungary remains unique in the region in the extent to which its privatisation has relied upon sales rather than the free distribution of state-owned assets. Hungary's approach has succeeded to a far greater extent than many observers expected and the country deserves credit for that. However, while one important function of privatisation is to "distance" former state-owned enterprises from the state, and to depoliticise business decisions, in this respect Hungary has not quite succeeded yet and further progress is needed.

Endnotes

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1. The authors are indebted to Attila Havas (IKU, Budapest), for extensive discussions and insights into the issues raised in this paper; to József Balogh (Rothschild & Sons Ltd) and Marcella Niklós (ÁPV Rt) for supplying invaluable background material and data on utilities privatization and regulation in Hungary; to David Newbery (Department of Applied Economics, Cambridge) for sharing his expertise on regulation of electric utilities in Eastern Europe; and to Ernõ Zalai (University of Economics, Budapest), for filling an important gap in our information

at short notice.

2. Canning and Hare, 1994; Hare, 1994. See also Voszka, ...; Estrin, 1994; ....

3. Not only in the CEE countries themselves; western analysts have constantly had to revise and refine their views on privatization since 1990 as the complexities of privatizing in the transition economies have become apparent.

4. Act No. XXV of 1991 on Partial Compensation for Damages Unlawfully Caused by the State to Properties Owned by Citizens, in the Interest of Settling Ownership Relations. This Act covered damages occurring under the socialist regime (from 1949); further legislation was passed in 1992 awarding compensation for damages suffered between 1939 and 1949, and in cases of persons deprived of their lives or liberty for political reasons.

5. Act No.XXXIII of 1991 on the Transfer of Certain State Assets to the Ownership of Local Municipalities.

6. Tamás Szabó, Minister without portfolio responsible for privatization, in a document introducing the voucher scheme, "Strategy for a breakthrough in privatization" (October 1992). See Canning and Hare, 1994, for more detailed discussion.

7. Tax breaks (up to ten years) granted to foreign investors before the end of 1993 were not, however, revoked. Although official policy documents of the period showed a clear distancing from the aim of attracting foreign investors, FDI nevertheless continued (and continues) to play an important role, both in privatization and in greenfield investment in Hungary. Hungary has remained the largest recipient of FDI of all the transition economies in CEE.

8. Csurka later went on to found the right-wing nationalist Hungarian Justice and Life Party (MIÉP), and has attraced sufficient support to be considered one of the more important non-parliamentary parties (alongside the hard-left Workers' Party (MP)).

9. The self-privatization scheme was in part a response to the lack of success of earlier, heavily bureaucratic privatization methods; firms eligible to participate in the scheme entered into a transformation/privatization contract with a consultancy firm selected from a list approved by the SPA. Privatization proposals thereafter only required formal "rubber-stamping" by the SPA in order to go ahead. (See Canning and Hare, 1994, for detailed discussion.)

10. See, e.g., Newbery (1994), Ordover, Pittman and Clyde (1994) for definition and detailed discussion of the issues surrounding natural monopolies.

11. Ordover, Pittman and Clyde (1994) give a useful summary of the literature on these issues.

12. See Valentiny (1994). Energy imports increased from 37% in 1970 to 54.6% in 1990.

13. Some, however, remained in the hands of the SPA, e.g. the power stations and the regional electricity supply companies. This was to lead to some embarrassment in 1993 when the Ministry for Industry and Trade and the SHC began privatization negotiations for MVM; the two agencies

appeared to be acting at cross-purposes when almost simultaneously the SPA prematurely (and unsuccessfully) initiated the sale of 15% of the shares it held in the supply companies.

14. ÁVü Közlöny (SPA Gazette), December 6, 1994, p. 14.

15. See also Mihályi, 1996, p.731.

16. I.e., to privatize MVM together with OVIT and the Paks nuclear power station, targetting principally smaller domestic investors, compensation voucher holders, and domestic and foreign institutional investors; a majority stake in the 6 electricity distributors and 7 power stations was to be sold to strategic investors.

17. National Mineral Oil and Gas Trust.

18. See Valentiny, 1994.

19. As Mihályi (1996) points out, the purchase price of fuel represents 70-90% of overall costs in the energy sector; reducing capital costs therefore has little, if any, affect on energy prices.

20. See, e.g., Voszka (1996) for detailed analysis.

21. This section draws heavily on the analysis of Zoltán Faludi (1995).

22. In the case of the regional gas companies, which previously enjoyed exclusive rights to supply in their respective geographical areas, the new licencing rules allow for competition to take place between suppliers applying for a licence to operate in areas not already served by a gas supply; MEH issues licences for such areas to the company offering the highest standard of service at the lowest cost.

23. A three-stage increase in prices was envisaged, commencing with an 8% increase effected on September 1, 1995; and increase of 25% on March 1, 1996, and culminating with a further increase taking effect on October 1, 1996, the level of which was to be determined later. At the end of 1994, consumer prices for natural gas remained below the import price.

24. Magyar Energiahivatal, "A földgáz árkiigazítási rendszere 1997-ig" (Structure for the adjustment of prices for natural gas up to 1997), March 20, 1995.

25. In the case of electricity, average consumer prices as of end-1994 were estimated to cover only 50% of costs.

26. OMRI Daily Digest, August 23, 1996; OMRI Economic Digest, August 29, 1996. The delay in raising energy prices is likely to cost the energy companies between HUF 100mn and HUF 1 bn (USD 660,000 - 6.6 mn), according to estimates published in the Hungarian dailies on September 2. The electricity companies are likely to be hardest hit; MOL Director, Zoltán Mándoki is quoted as saying that MOL's market value has fallen by HUF 16 bn as a result of the government's decision, and the company is expected to lose revenues of between HUF 2 and 4 bn. (OMRI Economic Digest, September 2, 1996).

27. In 1990, Hungary had fewer than 10 main lines per 100 inhabitants, among the lowest penetration rates in Europe, and even by comparison with the former socialist countries of CEE (the figure for the Czech Republic was 16; in Slovenia, 21, compared with 33 in Spain, and 44 in the UK). Potential subscribers could expect to wait on average 12 years for a line to be installed; 10% of exchanges were still operated manually and as many as 30% of rural communities had no private telephone lines at all. (See Canning, 1996.)

28. A ten-year development plan drawn up by Matáv itself in 1990 estimated the investment required to reach this level of penetration at around USD 2bn (at 1990 prices); in 1992, a survey published by the International Telecommunications Union put Hungary's investment needs over the eight years to the end of the decade at USD 3.5bn. (Heti Világgazdaság, Telecommunications Supplement, April 29, 1994.)

29. Constraints of space prevent detailed discussion of developments related to the provision of local services. A brief outline is warranted, however, to give an indication of the market position of the local companies vis-à-vis Matáv. Under the Telecommunications Act, Hungary was divided into 56 (later 54) so-called primary regions. Local authorities in 25 regions submitted applications which met the eligibility criteria for tendering for concessions to supply local telephone services, subject to similar terms and conditions (duration, exclusivity for a limited period, development commitment) as in the case of the concession for international and long-distance services. Regions not applying automatically remained in the hands of Matáv. Bids were actually received (February 1994) for only 23 of the eligible regions, 8 of which were awarded to Matáv and 15 to independent operators, predominantly US and French-led consortia, some to local government companies (in a number of cases with a foreign partner). The outcome: including the 29 uncontested regional concessions, and the two which failed to attract bidders, Matáv gained control over 39 local networks; these represented an estimated 80% of Hungary's local telephone market (see Canning, 1996).

30. The TCF is a non-profit making, non-political council. It receives funding from membership subscriptions and from the Telecommunications Fund. The Fund was set up by the MTTW for the main purpose of channelling resources (mainly concession fees, along with some central budget funding) into telecommunications modernization in less developed regions of Hungary.

31. In accordance with the government's policy decisions regarding the type of investor and commitment sought for Matáv, eligibility criteria included: operating experience (provision of telecommunications services to at least 1 mn subscribers); solvency (gross revenues from public telecommunications services of at least USD 1 bn in the previous 2 years); network development experience in the past 5 years.

32. Matáv's financial indicators were relatively poor, with productivity well below that of telecoms providers in many developing countries, and low profitability (its debt ratio was equivalent to almost half its registered capital). Its position improved, however, as a result of a timely capital injection (less than one month before the privatization deal was concluded) of HUF 8.55 bn, giving the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) a stake of 0.99% and 1.97% respectively in Matáv (post privatization and capital-raising), and in part substituting earlier loans.

33. As a result of its massive investment and development commitments, Matáv's profits fell to a mere HUF 97 mn in 1994, extremely modest given that its equity is around HUF 185 bn (Mihályi, 1996). Moreover, the value of Matáv shares (traded on Hungary's secondary markets) had fallen from 280% at the time of the first phase of privatization (December 1993) to 160-180% in summer 1995. The company also suffered heavy losses when the court, arbitrating in a dispute between Matáv and 13 regional concessionaries over the value of assets transferred by Matáv, found in favour of the regional companies.

34. Smaller stakes in Matáv (totalling around 5%) were transferred to employees, local municipalities and compensation voucher holders.

35. On the general issues of competition policy, see Fingleton et al. (1996).

36. For detailed discussion of privatization and changes in ownership in the banking sector, see Várhegyi, 1996.

37. These figures do not include sales below HUF 50 mn (e.g. under pre-privatization).

38. Act No.LXXIV of 1990.

39. See Voszka, 1996; Mihályi, 1996 for details.

40. Principally Pannon Váltó and the ERAVIS hotel chain. Most of the shares thus issued on the stock exchange were in fact bought by voucher-holding funds rather than individuals. (Mihályi, 1996.)

41. The two bodies were to receive assets totalling HUF 55- 65 bn; as of the end of 1995, only around HUF 10 bn had been transferred.

42. See Mihályi, 1996.

43. UN/ECE Economic Survey of Europe in 1994-95, Table 3.2.6.

44. These data are taken from the Internet (URL: http://www.ikm.hu/english), and should be regarded as approximations only.