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BANKRUPTCY REGULATIONS, POLICY CREDIBILITY
AND ASSET TRANSFERS IN HUNGARY



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SUMMARY

Apart from the normal, general tasks of bankruptcy, there are a number of special functions and tasks to be considered under the circumstances of transition. The introduction of bankruptcy must fit into a general sequence of institution building and economic policy. These aspects must be considered in the timing and design of a bankruptcy institution. When experts list the jolts undergone by the Hungarian economy in the early years of the transition, they frequently include the oft-mentioned demand shocks (collapse of markets, lifting of state protection, liberalization of markets, etc.) and some important institutional, 'supply-side' shocks. Some of these institutional shocks were as painful as the demand shocks, notably Hungary's harsh bankruptcy law, which called for major managerial effort from debtors and creditors, while closely affecting much corporate activity. For instance, the creditworthiness of firms changed almost overnight.

In terms of general economic policy, the message given by the circumstances of the introduction of bankruptcy may determine the way that economic agents interpret new institutions and government intentions and the credit they give to economic policy. For bankruptcy is among the basic institutions for enforcing property rights and contract law, and the main means by which the negative consequences of risk taking and failure can apply. The absence of credible bankruptcy practice will encourage opportunistic behaviour by agents, in commercial relations and in their approach to other institutional reforms, including privatization. Realization of the limits of state intervention and the simultaneous opportunity for managers to become owners (or at least to influence the privatization of the firms they manage) encouraged them to curb their opportunistic prac-

tices and concentrate on strategic adjustment. The limits on adjustment were in most cases due anyway to inadequate financial resources rather than opportunistic behaviour or incompetence. Hungarian privatization gained momentum at exactly the same time as the new bankruptcy law was introduced.

However, it is important to emphasize that asset transfers were promoted by the bankruptcy law through several channels. There was a clear direct impact from the physical exit of firms from markets, resulting in liquidation and asset sales, but adjusting firms were also forced through bankruptcy and privatization, so that assets could be reallocated wherever possible to uses that offered a better return. This produced a massive flow of assets, despite the fact that local capital markets were still rudimentary. Asset transfers were typical for all the adjusting firms – for those who did this successfully and escaped formal market exit, and for those who did not.

The introduction of the new bankruptcy law caused massive macroeconomic changes. Although the law itself was not responsible for the shocks or the reasons behind corporate failures, it triggered them simultaneously in many companies. The negative microeconomic developments, coinciding in time, compounded to cause serious macroeconomic problems. One-third of the economy was threatened by liquidation and in a financial state to justify such a procedure. Fears of severe consequences were understandable, but the bankruptcy institution proved to be efficient in reducing losses to a considerably lower level.

Three factors can be mentioned. First, the regulations showed preference for reorganization for nearly two years, then an amendment practically closed the paths to *de jure* restructuring. This meant that the

law, in the initial, most serious period, provided opportunities for sides to reach a settlement. Secondly, when formal reorganization was contained, the law still allowed liquidations to transform into reorganizations in cases where the debtor was retained as a going concern and its activity was regarded as viable. The restructuring of debtors was promoted mainly by the way liquidators were remunerated. This side of the law seriously weakened the position of creditors in liquidation proceedings, since they were no longer awarded increased control over the activity of the liquidator. But the outcome of the changes was that liquidators took over the role of formal reorganization. The latter disappeared, but wherever some production or meaningful activity by the debtor remained, the liquidators would exert themselves to maintain and consolidate that activity.

The third factor that ameliorated the consequences of bankruptcy was action by the state. Ministries and still more the State Privatization Agency played an active role in avoiding crises and made efforts to bail out certain firms. Most importantly, it mediated among the parties – who in some cases were almost exclusively representatives of the state. It is argued in this paper that state intervention in bankruptcy proceedings is undesirable, especially in the early phase when proceedings are triggered. Hungarian practice generally allowed the proceedings to start, but there was intervention in several cases when important firms could not be rescued through either of the other ‘built-in’ factors. The number of firms that benefited from direct state intervention was confined to one or two dozen, so that these few exceptions did not undermine the new-found credibility of economic policy.

Reorganization agreements were also promoted outside judicial proceedings. Banks were urged to settle their disputes with debtors and manage their non-performing portfolios. The law on financial institutions required banks to establish portfolio-management departments and prescribed strict prudential regulations. In

addition, the state put up very considerable sums of money, to help banks to build up the necessary risk reserves and to compensate them to some extent for writing off certain parts of their debt portfolios. Bank recapitalization was in fact the strongest direct action undertaken by the Hungarian government to eliminate the liquidity problems in the economy. The bank consolidations were not very damaging to credibility. The customers (debtors) of banks were not affected directly. Banks usually did not write off the obligations of active firms, which were rescheduled or converted into equity instead. On the other hand, the elimination of non-performing assets was enhanced. As far as banks themselves were concerned, cleaning up their portfolios was a precondition for privatization to foreign buyers. The prospect of privatization provided the safeguard against bank opportunism.

The outcome of bankruptcy proceedings also has to be gauged in terms of asset restructuring. Asset losses, that occurred in the event, cannot be regarded as transfers, but they are an important constituent of restructuring – the necessary Schumpeterian process of creative destruction. They are not necessarily connected directly with bankruptcy, on which real asset transfers may depend either directly or indirectly. The direct link is most obvious in a sale of assets under a reorganization agreement or liquidation proceedings. Asset transfers, on the other hand, occurred also in day-by-day business, in some cases linked indirectly to bankruptcy, as firms sold assets to avoid bankruptcy – to gain cash and repay debt or change corporate activity and avoid a prospective long-term crisis. Without the threat function of bankruptcy, this type of asset restructuring might not have occurred or been less vigorous. The mere existence of the bankruptcy institution can therefore trigger major restructuring activity, including asset transfers.

INTRODUCTION

The success of the transition depends greatly on microeconomic changes and basic restructuring of corporate activities. The long-term adjustment process necessitates a general modernization, while technical modernization calls for new products and production facilities, or occasionally changes in the character of activities: exit from one market before entering another, in which a firm may have competitive advantages. This longer-term adjustment, called 'strategic restructuring' by Grosfeld and Roland (1996), presupposes changes of activities: downsizing of less competitive ones and modernization and development of others. Changes of this magnitude are often carried out through asset restructuring and transfer, including the sale of some assets and the purchase of others.

The asset restructuring and long-term adjustment of firms can be enhanced by measures of economic policy. The starting point is the changing environment. If market changes are cushioned by policy measures, firms no longer feel the market forces acting upon them, so that restructuring may be delayed or prevented. On the other hand, it is possible to amplify the positive, desirable reaction of firms to market forces. Bankruptcy institutions may serve to encourage business associations to face the challenges and make the positive adjustment steps expected of them. In an ideal case, the asset transfers and restructuring that result from adjustment activities will occur in time to prevent a company's financial position being critically undermined. If the latter should happen, the channels and tools for adjustment may derive from bankruptcy. The judicial frames of reorganization may be replaced by out-of-court settlements, if need be. In either case, bankruptcy plays an important direct and indirect role in the process of corporate adjustment and asset restructuring.

The empirical part of the research project described in this paper deals with asset restructuring and the circumstances in which old assets are used by new owners in Hungary. The focus is on the theoretical background to the questionnaire design, with two purposes in mind. (i) The paper sets out to summarize the main policy-related consequences of the bankruptcy regulations, in the ninth year since the introduction of the new bankruptcy law. It looks primarily at issues that directly affect corporate activities, including decisions on asset restructuring. (ii) The other task of the paper is to describe the major avenues of asset restructuring and estimate their relative weights. Both these purposes are relevant to the empirical survey. The first provides information for the questionnaire design, highlights the most important relationships between the parties, and reveals the major reasons for failure in the old use of assets and potential success in the new. The second helps in arriving at a careful balance in the sample structure, between different ways of asset restructuring.

SOME GENERAL AND SOME TRANSITION-SPECIFIC FEATURES OF BANKRUPTCY REGULATIONS

That actors in the economy should suffer the consequences of failure is as essential a component of a market economy as the risk taking essential to a market economy. Bankruptcy regulations have to strike a balance, ensuring that the consequences of business failure work to guarantee basic property rights (claims by creditors and owners) without inhibiting risk taking. The balance is also supported by a web of other measures, such as existing property laws and mechanisms of enforcement, secured credits, foreclosure, creditor control over debtors, watchdog institutions, and so on. These regulations affect each other directly or indirectly and the interplay between them strongly influences the behaviour of

creditors and debtors. For example, if the bankruptcy regulations fail to protect creditors' property rights sufficiently, creditors may prefer to foreclose on their collateral rather than relying on bankruptcy. The choice here depends also on the maturity and current conditions of the capital markets and on the overall economic situation. These general conditions determine success in using the various tools for securing property rights.

Bankruptcy and liquidation occur when other, less radical paths out of failure are closed. The physical exit of a firm from the market is followed by the sale of its assets. Bankruptcy is therefore directly linked with asset restructuring. Asset restructuring may also feature in less drastic solutions to financial distress. Corporate failure may be preceded or forestalled by downsizing and avoidance of bankruptcy, through out-of-court settlements between creditors and debtors or formal reorganization. Asset restructuring is not necessarily bound to firms' market failure and bankruptcy, for in a broader sense, it is part of the resource-allocation system of a market economy. If resource allocation were perfect and efficient (based on sufficiently available information by all market participants), there would be no need for bankruptcy to exist. Resources would always flow to where they would gain the highest returns. Imperfect financial markets and information asymmetry between insiders (managers) and outsiders (claimants) bring a need for separate guarantees for creditors.

Bankruptcy has several important basic functions in supporting asset reallocation. Selection is performed by the institution of bankruptcy when company managers fail to make efficient use of assets. This forces unviable economic units or corporate activities effectively to exit markets and allocate their assets to more efficient uses. Bankruptcy also has personal consequences for managers. The increasing control by creditors or the sale of assets may cost them their jobs. Thus manager failures threaten their future incomes and devalue their position on the labour market. This threat is an

effective restraint on managers, dissuading them from misusing their superior stock of corporate information.

The problem of information asymmetry emerges already under normal business conditions (expressed by the well-known principal-agent problem). The problem becomes more complicated in the case of corporate failure, where managers' insider knowledge may also be used against creditors, as they behave opportunistically and try to avoid failure and potential liquidation by pursuing risky undertakings. The rescue operations they try may exhaust much of the company's asset stock or increase its debts, with managers viewing the higher risk of failure as immaterial. For creditors, careful evaluation of risks and potential benefits is vital if they are not to lose more or throw good money after bad. Opportunistic behaviour by managers can be avoided if strong negative consequences are in sight and the control of bankruptcy by creditors is sufficiently increased.

Apart from the normal, general tasks of bankruptcy (selection, exit, threat, enforcement of property rights), there are a number of special functions and tasks to be considered under the circumstances of transition. The introduction of bankruptcy must fit into a general sequence of institution building and economic policy. These aspects must be considered in the timing and design of a bankruptcy institution. The first such condition concerns the responsibility of corporate managers of hitherto state-owned firms in financial distress because of decisions taken before the change of system. For instance, longer-term investment decisions suffer especially if the original rationale disappears after changes that nobody had predicted, or decisions were not even taken or executed by corporate managers. The responsibility of management for corporate failure in the first period of transition is low, so that the threat function of bankruptcy is not very strong.¹

¹ It is another matter that management's responsibility gradually increases to a later peak, by which time the threat function of bankruptcy has probably taken

Because the reasons for financial failure may be exogenous, it may also be useful to shape the bankruptcy regulation in a way favourable to the debtor. Bankruptcy proceedings should further corporate restructuring rather than liquidation. Faulty decisions in the past do not necessarily imply that a company is not now viable and its assets should be reallocated. Creditors, on the other hand, may argue that transition shocks affected other parties as well, and their chances of successful adjustment are not enhanced by pro-debtor bankruptcy regulation. Creditors may need to collect receivables to stabilize their own activity, so that support for debtors may exacerbate the financial situation of creditors, by producing sustained payment arrears. A pro-creditor design for the bankruptcy institution is also supported by the argument that adjustment is best enhanced by rigorous bankruptcy rules. The strengthening of property rights must be given high priority in countries where they were neglected for decades. It may also be easier to introduce full-scale regulation overnight than go for a gradual introduction.²

The next specific feature of transition economies is the large number of firms in financial distress. Relatively few firms in mature market economies get into financial trouble deep enough to warrant the use of bankruptcy. Signals of trouble are sighted in good time for corrections or even potential reallocation of assets to be made. In the transition economies, distress among firms, especially important, big state-owned enterprises were troubled on a mass scale. Their simultaneous reorganization or liquidation was not simply problematic from the technical point of view (little experience with bankruptcy, shortage of liquidators and judges, lack of experience of creditors).

effect.

² Experiences with gradual institutional reform have shown up inadequacies in the approach in many cases. The biggest dangers to institutional reform are to allow many exceptions, to grant temporary exemptions from legal stipulations, or to introduce government agencies to perform functions that should be automatic.

It was also difficult to cope politically with many bankrupted firms, because of the massive unemployment and loss of assets entailed, and the possibility of opportunistic behaviour by existing management (asset stripping). On the other hand, the disciplinary force of new institutions, including bankruptcy, acted to enable effective adjustment and prevent the other type of opportunism, which is free riding.³

Another core issue of bankruptcy regulation, apart from striking an adequate balance between liquidation and reorganization, is the triggering of the proceedings. Ideally, interested parties should be prompted to initiate proceedings by self-interest. Creditors and debtors alike may find this benefits them. Creditors may gain control over how their claims are used and influence over management and liquidation decisions (probably resulting in a partial settlement of their claims). Debtors may file for reorganization in the hope that a settlement with creditors may avert failure.⁴ The judicial proceedings of reorganization, however, are usually avoided through out-of-court agreements, especially in countries with stringent bankruptcy regulations (such as Germany), where reorganization entails substantial administrative difficulties.

One of the biggest problems with the bankruptcy institution in transition economies is the reluctance of both creditors and debtors to institute proceedings. With debtors, this is mainly due to weak, debtor-

³ Opportunistic behaviour by corporate management is commonly observed in Eastern European countries. The courting of favours or subsidies is not confined to state-owned enterprises, as the old, paternalistic relationships and behaviour survive privatization. Ineffective privatization methods and tentative institutional reform help to undermine the credibility of economic policy. Although it is less surprising to find old paternalistic ties surviving in the CIS countries and the Balkans, Brom and Orenstein (1993), Stark (1996) and McDermott (1996) draw attention to the possibility of similar linkages in strongly transforming countries such as the Czech Republic and Hungary.

⁴ Reorganization in mature market economies shows a remarkably high proportion of success, in which creditors avoid further major losses and an efficient reallocation of assets (change of activities) occurs.

friendly bankruptcy law that is weakly or hesitantly enforced. This lack of determination in starting and supporting microeconomic restructuring through bankruptcy derives from fears of the economic and political consequences, sometimes hidden behind other considerations of institutional development. For example, companies participating in the Czech voucher-privatization scheme were exempted from the terms of bankruptcy law, as was the whole agricultural sector. The argument advanced – that the success of privatization policy depended largely on the performance of the participating companies – was a false one, since the real, long-term performance of the companies concerned was not dependent on the introduction of the bankruptcy law. Masking the problems postponed the solution of them and exacerbated the situation in many cases. Such weak enforcement of the law formed part of the ‘superficial transformation’ of the Czech economy.⁵

The reasons for creditor passiveness in instituting bankruptcy have been discussed thoroughly by Mitchell (1993). The one factor to emphasize here is the role of state, in weak enforcement of the law and behaviour that reflects a complex web of vested interests. For the state plays multiple roles in this situation. It is responsible as a reformer for developing the basic institutions of a market economy. Meanwhile, it has a responsibility as the owner of the largest debtor firms for restructuring and for any losses occurring in the process. Furthermore, the state is among the creditors, because the major banks and many important suppliers will be state-owned. Thus the state, through its agents (manag-

ers), holds all the important positions and autonomous managerial decision-making becomes almost impossible. Corporate autonomy proved unable to develop fully in the reforming Hungarian economy before the transition, in a period when the business environment was less troubled. The state in all the transition economies remained activist in its behaviour long after the initial months and years of transition. The interests of the affected parties of financially ailing companies are therefore complicated. Orderly solutions are impeded by opportunistic behaviour by management and by conflicting interests among various government agencies.⁶ Under such circumstances, debtors and creditors alike might also hope for state intervention, *i.e.* a partial or total debt write-off. This expectation proved realistic in all transition economies, where governments decided on major bailout programmes.

Faced with the passiveness shown by creditors, Hungarian legislators introduced into bankruptcy law an automatic trigger, which worked effectively. Firms defaulting on payments for more than 90 days, regardless of the amount, were legally bound to file either for reorganization or for liquidation. The responsibility of filing under these conditions lay with corporate managers. Consequently, a massive wave of bankruptcies started in April 1992, with several thousand filings a month until the end of that year. Several parallel laws were introduced to support the proper functioning of bankruptcy. Measurement of the financial and business situation of firms and selection of viable and non-viable activities

⁵ Some other transition economies likewise eschewed drastic bankruptcy practice as a way of enhancing structural changes. In the Ukraine, for example, a special presidential committee was charged with deciding whether bankruptcy law should or should not be applied in specific cases. Similar practice was pursued in Romania. Governments repeatedly announced that a number of big, ailing companies had to undergo bankruptcy proceedings, only to back-track when faced with savage populist attacks from the opposition.

⁶ With reorganization negotiations, for example, representatives of the state as owner perform the roles of both creditor and debtor. Also involved are agents of several state authorities (tax, social security, customs), and occasionally people from ministries responsible for regional development or industry. Hungarian practice showed that a reorganization plan could only be arrived at after being sanctioned at the highest level (usually by the Ministry of Finance), as state creditors would pass the responsibility for deciding up to this level. Commercial creditors, on the other hand, usually bargained singly.

were supported by a new law on accounting, which required, for example, proper classification of receivables and the revaluation of assets. New accounting methods allowed managers to evaluate the conditions of different activities separately. The new law on banking prompted the banks, the biggest creditors, to face the problems of managing bad debt.⁷ However, the passiveness of the banks was not reduced simply by this. Management of the large amount of bad debt that was revealed was solved only by major state intervention. Several months and years passed before the banks established the necessary departments and gained experience in bad-debt management. The ultimate spur to proper debt management by banks came with the preparations for effective privatization, which entailed mastering the problems with ailing debtor clients.⁸

HUNGARY'S 1992 INTRODUCTION OF THE INSTITUTION OF BANKRUPTCY

Authors frequently list the jolts undergone by the Hungarian economy in the early years of the transition. They include the oft-mentioned demand shocks (collapse of markets, lifting of state protection, liberalization of markets, etc.) and some important institutional, 'supply-side' shocks. Firms had to adjust their activity to changing demand and concurrently to changing institutions. The new accounting practice, for example, required firms to make a complete overhaul of their accounting systems, involving the retraining of staff and computerization.

⁷ New, stringent prudential regulations were introduced and banks were required to set aside adequate reserves for risk coverage.

⁸ Despite the strong efforts of the banks and the government, there were still cases where a foreign buyer had been unable to survey properly the position of a purchased bank, which led to long debates and disputes. Ultimately, the state had to take over further parts of the bad debts of banks that had already been privatized.

Major managerial effort and outlay also went into adjusting to the new tax, social-security and customs systems and many other conditions. The introduction of new practices with new or reformed institutions set obligatory 'homework' for managers and firms that were more or less strictly controlled, and in doing so, used up time, money and managerial effort that could equally have been used to develop responses to demand shocks. Some of the institutional shocks were as painful as the demand shocks, notably Hungary's harsh bankruptcy law, which called for major managerial effort from debtors and creditors, while closely affecting much corporate activity. For instance, the creditworthiness of firms changed almost overnight.

The double set of shocks prevented most companies from adjusting rapidly in 1990–91, before the introduction of the bankruptcy law. They simply lacked the necessary human and financial resources to do so. Many state-owned firms had high expectations of state intervention, which led them to pursue a wait-and-see policy (Laki, 1994). They even felt that passiveness was ethically correct, since managers could hardly be blamed for the current bad situation. The credibility of economic policy had not yet been established at this time, so that the expectations of a state bailout seemed realistic. Firms continued to produce for stock and their debts continued to build up. The high inventory levels and the aftermath of the high borrowing in the 1980s for major investment projects placed a high debt burden on many companies. Corporate finances suffered badly from soaring interest rates, which effectively multiplied debt-servicing obligations that could not be financed from declining sales revenues. New credits were still being extended and old ones rolled over.

Kornai (1993) identified as the underlying problem in establishing and operating a market economy the survival of soft budget constraints, which allowed firms to postpone their adjustment to the two sets of shocks. The most obvious signs of softness were measured on four levels of loose pay-

ment discipline. Firms paid for their supplies after long delays or not at all, so that a large volume of inter-company debt arrears emerged. Debtors failed to meet their obligations (violated their debt contracts). Debt arrears also accumulated with organs of the state (tax, social security and customs). Finally, Kornai stated that most companies were unable to finance operating costs from sales revenues, so that they made trading losses, not profits.

Periods of recession may occur when most companies sink below profitability. Although there is a time lag between supply and payment, whose length varies in different nations and trades, the question here is whether the level of arrears was normal and potentially improving in Hungary – if the general loss-making by companies was temporary or chronic in character. Could economic policy-makers hope for a general improvement without major intervention, of a restrictive type or in the form of massive bailouts? The decision to introduce the bankruptcy law shows that the Hungarian government did not believe spontaneous correction would occur. The liquidity position of firms continued to decline throughout 1990 and 1991, with high debt arrears accumulating in all three directions, especially among firms. The liquidity crisis threatened to bring a breakdown of the financial system, as firms began to avoid using banks in inter-company settlements, and cash payments and barter gained importance.⁹

⁹ If the similar experiences of most CIS countries are ignored for a moment and the issue considered from a market-economic angle, it becomes easy to appreciate the extraordinary dangers. Consider what would have happened to Austria, for example, if it had lost its German markets and cooperating partners, for Hungary suffered an equivalent upset when it lost its former COMECON markets and partners. A very similar situation would have emerged in Austria, undermining the value of its currency and the position of its banks. Customers would have let down the Creditanstalt and Hypobank, stopped money transfers, and perhaps even abandoned the local currency in favour of German marks or US dollars, on a strictly cash basis. One can hardly describe any such situation as normal, and as the CIS countries or the example of Yugoslavia show, it is not an impossible event. Begg and Portes (1993) also include po-

Curing the liquidity problems in the Hungarian economy by strengthening financial discipline was the main purpose of introducing a bankruptcy law with an automatic trigger, along with the laws on accountancy and financial institutions mentioned earlier. This, along with general considerations of institution building, was the single most important policy goal of the moment. Kornai (1993) gives figures for inter-company debt arrears in the 1980s and early 1990s, using the list of companies banned from the Hungarian National Bank's rediscount list. In other words, the data cover firms and corporate debt not only formally overdue, but rated by the central bank as non-performing. The stated amount of this in April 1992 was almost HUF 200 billion. Szanyi (1999) put at another HUF 150 billion the amount of bad debt accumulated by banks, while a further HUF 150 billion was owed to state organizations. The early 1992 level of debt arrears, to the tune of almost HUF 500 billion, was equivalent to 21–2 per cent of 1991 GDP.¹⁰ After the introduction of the bankruptcy law, the number of companies on the National Bank list and the totals owed decreased substantially, to HUF 74 billion by the end of the year. Since then, the amount has varied between HUF 40 and 80 billion, which is a remarkable decline, especially if inflation is considered.

Arrears of debt owed to the social-security system appear in *Table 1*. These accumulated rapidly until 1992, when the process slowed and then levelled off in 1995. Thereafter, further slight increases were caused mainly by increments of interest and fines charged, without sizeable amounts of new debt being incurred. The trend was influenced by stronger debt collection and by stronger corporate payment discipline and strengthening of the budget

tential breakdown of the financial system in their list of the dangers from loose payment discipline.

¹⁰ Debt arrears may have been higher in some other transition economies fighting more notorious liquidity problems. In their case, perhaps as frightening as the level of debt itself was the ample evidence of failure of the financial system.

constraints. This is even clearer if it is remembered that much of the debt was accumulated by a handful of state-owned firms and institutions. The biggest debtor is Hungarian State Railways (MÁV Rt.) which owes over HUF 7 billion, but even the tax authority itself owed several hundred million in certain periods!

Table 1
Outstanding claims by
the social-security system
(HUF billion)

Year	Principal claims (1)	Fines and interest (2)	Collected debt (3)	Principal debt (1-2+3)
1990	23.9			23.9
1991	54.4	7.2		47.2
1992	90.6	15.5		75.1
1993	141.7	26.6		115.1
1994	189.1	45.6	15.0	158.5
1995	222.9	58.6	30.6	194.9
1996	221.5	66.8	36.7	191.4
1997	230.0	80.7	36.5	185.8

Source: Népszabadság, March 7, 1998 and own calculations

The declining trend in settlement arrears is clear, but it is not clear whether the decline was triggered by the new bankruptcy law. Some observers (Bonin and Schaffer, 1995; Schaffer, 1997) argue that the liquidity problems of the Hungarian economy did not require such harsh measures and the improving trends could have been produced at less cost by relying on other, indirect tools, such as financial-sector development. According to Bonin and Schaffer (1995), payment discipline was not bad enough in 1991 to warrant the introduction of such harsh bankruptcy regulations. They argued that much of the accumulated debt was inherited from the previous economic system and the liquidity problem had a stock character rather than a flow character. After analysing bank portfolios, they stated that extended new debt was a less important reason. According to Kornai's data on inter-company debt arrears and our data on public debt, it is clear that corporate debt accumulation accelerated in 1990–91, at least in these two directions. According to other sources (*The Banker*, July 1992), less than 40 per cent of

the stock of corporate debt held by banks in 1992 originated from the period up to 1990. The majority was due to new borrowing, although some of it may have been good money being thrown after bad, through the rolling over of old debt. However, the possibility of rolling over non-performing debt is in itself a clear sign of a soft budget constraint.

Evidence of declining debt arrears after the new bankruptcy law was introduced is described in Bonin and Schaffer (1995) as a 'statistical illusion' resulting from the temporary ban on foreclosures and debt collection. After filing for reorganization, banks did not report banned bad debt. This is also a weak argument. Such claims would become due again after the period of grace expired (even if restructured by the reorganization agreement) and no such subsequent major increase in debt arrears can be observed. Thus, the stock of bad debt must have been curbed in the longer run by the new law.¹¹

Schaffer (1997) refined the argument and analysed other areas of payment discipline besides bank debt. Of the four areas in which Kornai (1992) identified soft budget constraints, there were no major problems in three before the introduction of the law. Temporary loss making in periods of recession is normal in mature market economies as well. Schaffer also analysed macroeconomic statistics of the general stock of debt in the economy (end-period receivables as a percentage of GDP, instead of the National Bank data for qualified bad debt), finding that it was not very high or increasing very rapidly. What really happened, in his view, was a sudden increase of debt to public budgetary funds, while the general level of debt and average term of payment were not very great by international standards.

¹¹ It is another matter to say how much banks were able to collect and how much they had to write off. The fact is that there was an improvement – a drop in the stock of debt – so that the old debt eliminated significantly exceeded the amount of new non-performing debt building up. This also means that the practice of rolling over old debt had been limited at least.

Our interpretation of these facts is different. An increase in debt to public budgetary funds up to 1995 may be evidence of the limitations of the new law in imposing hard budget constraints on economic agents. What probably happened was a shift of debt accumulation from commerce (banks and suppliers) towards the public sector between 1992 and 1995.¹² But this does not falsify our assertion that corporate payment discipline in the inter-company and bank relations was weak on the eve of the introduction of the law. Nor does it contradict our other statement that improving payment discipline in commercial ties was largely due to the new law. It proves only that the debt problem was hard to master and companies took the opportunity to move some of their debt onto the least efficient debt collector, which was the state.¹³ The argument that the indebtedness was not high by international standards and the payment periods not exceptionally long is based on false comparisons. What really matter are changes, not absolute levels. Countries on Schaffer's lists that work with shorter payment periods (say Scandinavian countries, at 1.6 months) would probably not regard as normal abrupt changes in the conditions, even within the scope of other countries' levels (say Italy's 3.0 months or France's 3.5).

Rostowski and Nikolic (1998) collected figures on real bank credit to enterprises, finding that the level of new credits extended to enterprises stagnated in Hungary between 1989 and 1993 compared with other transition economies, while it fell substantially in the Czech Republic, Slovakia and Poland. This lending behaviour by banks is especially remarkable because GDP declined by over 20 per cent in the same period. In our view, this is further evidence

of soft budget constraints in the financial sector.

Hardening the still soft budget constraint was one important factor behind the new law. Another was enhancement of corporate adjustment. The transition period called for structural changes and restructuring of assets on a large scale. This was the primary, long-term way of making corporate adjustment. Several surveys collected empirical and anecdotal evidence of corporate adjustment in the early transition years. Laki (1993) and Török (1993) stressed the passive, wait-and-see attitude of large state-owned enterprises, which hardly acted to change their bad and worsening situation. More optimistic observers identified minor, if rather defensive changes (Szanyi, 1992) described by Grosfeld and Roland (1995) as 'defensive restructuring'.

Defensive restructuring was aimed mainly at selling assets to cover financing activities (or losses). Asset transfers usually started with welfare facilities (sporting lots, holiday centres and the like), continued with expensive headquarters, and finished with the sale of production plants, industrial estates and machinery (at scrap prices in many cases), until the assets were exhausted. Defensive restructuring was not usually controlled by the owners, so that the risk of opportunistic behaviour was high.

Asset sales amounted in many cases to asset stripping, with managers selling valuable assets at low prices to their own agents. Asset stripping and depletion of assets continued in many cases until bankruptcy was declared, or until the privatization agency put a stop to the process. In the present context, the mere fact that defensive restructuring resulted in mass transfers of assets to new owners is particularly interesting.

Yet other observers have also found cases where defensive restructuring advanced from the mere sale of assets to initial steps of adjustment (Belka, 1993; Szanyi, 1996). Many companies went on from reducing their unprofitable assets and activities to internal restructuring. The first ac-

¹² This shift was also confirmed by Mitchell (1997).

¹³ Mitchell (1997) provided data about the changing behaviour of state agents towards debtors in 1995. Economic policy changed: because the high level of public debt led to more emphasis on debt collection, including the initiation of bankruptcy proceedings, so that the state became a more rigorous creditor.

tions usually included establishing up-to-date information and communication systems at plant level and introducing new management practices involving high quality and rapid information transfers. This approach rapidly improved management efficiency and flexibility, leading to improved performance.

Research has also been done into the reasons for 'improving restructuring' (Szanyi, 1996). Companies recognized that the changes in their environment were not temporary and the twin shocks had heralded a new business epoch, while the state was unable and willing to launch mass rescue programmes to absorb the shocks.¹⁴ What tended to convince economic agents that they were on their own was the increasing credibility of economic policy. The other important boost to such credibility came from effective privatization. Bankruptcy and privatization together persuaded managers to try to shape events according to their own expectations and interests, according to the rules of the game. If they did nothing to forestall market exit, no one was going to give them a hand. But if they adjusted and saved their company, they would have a say in the process of privatization as well. The stick and carrot were provided, and many companies susceptible to reorganization were converted into viable busi-

¹⁴ Shock absorption in the transition economies took a variety of forms. The crucial difference in Hungary was that the limits of state intervention were set early and more or less observed. Direct or indirect subsidies to state firms were quickly reduced and not continued in elusive indirect forms, as in many other countries. McDermott (1996) and others demonstrated that the cross-ownership created through Czech privatization was an effective tool for covert subsidization of formally privatized companies. This support then postponed real corporate adjustment. Another frequent method of covert subsidization was exchange-rate policy. The stabilization programme introduced would include massive currency devaluation that artificially enhanced the cost competitiveness of firms, even if they had done nothing to improve their activities. This was especially true if there was a big overshooting in the devaluation. Rostowski and Nikolic (1998) provided evidence of massive subsidization through exchange rate policy in the Czech Republic and Slovakia. This period was much shorter in Poland and virtually absent in Hungary, where there was no major real devaluation.

nesses, despite the hardships of bankruptcy.¹⁵

This, in the author's view, gave the decisive impetus for massive, effective corporate restructuring, even if it did not result in immediate 'strategic restructuring', mainly for lack of capital and because of high exit barriers. One major survey of corporate investments indicated that firms not in foreign ownership were usually unable to conduct massive investment projects resulting in complete updating or change of their activities, for lack of the financial tools (Szanyi and Szemlér, 1997). But after the establishment of a credible economic policy, restructuring began and slowly gained scope and pace, producing in the medium term ventures that were successful and competitive. Credibility of economic policy was established through the interplay of bankruptcy and privatization.

PRIVATIZATION AND BANKRUPTCY AS THE PILLARS OF A CREDIBLE ECONOMIC POLICY IN HUNGARY

This chapter continues the analysis of the relationships between privatization and bankruptcy practice in Hungary. Reference has already been made to the importance of the timing and sequencing of new bankruptcy laws in transition economies. In terms of general economic policy, the message given by the circumstances of introduction may determine the way that economic agents interpret new institutions and government intentions and the credit they give to economic policy. For bankruptcy is among the basic institutions for enforcing property rights and contract law, and the main means by which the negative conse-

¹⁵ Maybe the long experience of Hungarian economic policy-makers with various methods of giving managers incentives to behave according to expectations provided what in our view is an effective way to stimulate corporate adjustment.

quences of risk taking and failure can apply. The absence of credible bankruptcy practice will encourage opportunistic behaviour by agents, in commercial relations and in their approach to other institutional reforms, including privatization.

The first and most important link between bankruptcy and privatization has already been described. Realization of the limits of state intervention and the simultaneous opportunity for managers to become owners (or at least to influence the privatization of the firms they manage) encouraged them to curb their opportunistic practices and concentrate on strategic adjustment. The limits on adjustment were in most cases due anyway to inadequate financial resources rather than opportunistic behaviour or incompetence.

Hungarian privatization gained momentum at exactly the same time as the new bankruptcy law was introduced. In the first two years of transition (1990–1), the privatization agency was engaged in its own establishment and development and with the problem of stopping spontaneous privatization. In fact, privatization policy was aimed at maintaining and securing state property rather than at reducing it. Privatizers, as representatives of the state owners, had strong remits to engage in corporate decision-making. They were allowed to override management decisions and even decide at day-to-day, operational levels, if they saw state property being threatened by managerial opportunism or incompetence. This early period of privatization policy curbed the autonomy of managers without putting forward an alternative solution. The privatization agency had no time and staff to make operative decisions itself, but it did not allow autonomous decision-making either. This failure led to crises in many companies, exactly at a time when external shocks were calling for deliberate action.

Managers were discouraged from making strategic decisions even if the privatization agency had not taken direct control of the company. The strong emphasis on stopping spontaneous privatization and

asset stripping was seen as a threat to managers, who therefore postponed many urgent decisions on asset restructuring, for fear of accusations of asset stripping. The paradox is strong. The external shocks called for massive adjustment responses, including the reallocation of assets, which were precluded by the distrustful privatization policy. Uncertainty was increased because discussions about privatization methods and policies were still taking place at this stage. Managers did not know what behaviour was expected by the privatizers or potential owners, and their willingness to make strategic decisions was undermined further by the ownership uncertainties. One consequence, in many cases, was a dramatic deterioration in the corporate financial situation, with the serious liquidity problems already described.

This strange situation began to change in 1992, with the introduction of the three basic laws and a change in privatization policy. By this time, spontaneous privatization had effectively ceased, while the structure of the privatization agency had consolidated and sufficient staff been recruited, and most importantly, the directions for an active privatization policy had been set. The ownership uncertainties had been considerably reduced. Managers knew at least what they could expect (including the roles they might potentially play), even if they did not know who would be the new owners. Distrust of managers also decreased with the passage of time and personal acquaintance between them and the privatizers. The emerging privatization policy and the inefficiency of the privatization agency, however, seriously contributed to the massive liquidity crisis in the corporate sector.¹⁶

¹⁶ It should not be forgotten that the overwhelming majority of essential economic activity was still carried out by the state-owned sector. Although the external shocks were exacerbated by ownership uncertainty, resulting in corporate failures, there is considerable evidence of weak performance in the existing private sector as well. Many of the flagship companies of 'goulash communism' also failed in this period. It seems that the external shocks affected private and state-owned firms alike.

From the angle of this survey, it is important to emphasize that asset transfers were promoted by the bankruptcy law through several channels. There was a clear direct impact from the physical exit of firms from markets, resulting in liquidation and asset sales, but adjusting firms were also forced through bankruptcy and privatization, so that assets could be reallocated wherever possible to uses that offered a better return. This produced a massive flow of assets, despite the fact that local capital markets were still rudimentary. Asset transfers were typical for all the adjusting firms – for those who did this successfully and escaped formal market exit, and for those who did not.

The next question to consider was whether privatization or the character of privatization policy could save firms from bankruptcy and market exit. Balance-sheet analysis of Hungarian firms, private and state-owned, produced no evidence that either group performed better in the period up to 1995. Voszka (1997) and Csányi (1997) both found a statistically insignificant difference between state-owned and private firms in the Hungarian economy.¹⁷ This we interpret as evidence that privatization alone could not effectively alter the fate of firms, at least in the short run. Privatization was no panacea, and factors other than ownership determined the chances of stabilization at corporate level, the major ones being sector, spatial location and manager capabilities.

Ways and means of privatization might influence adjustment capabilities and performance, however. This problem was at the centre of the criticism of voucher privatization, which in the case of the Czech Republic, produced unclear governance patterns that effectively blocked corporate adjustment and long-term improvement of

performance.¹⁸ The emergence of liquidity problems in the corporate sector of virtually all transition economies suggests that it was impossible to escape the tasks of adjustment and structural changes by any privatization method or state cushioning of economic shocks.

Frydman and Rapaczynski (1994) also list among the tasks of privatization the replacement of incumbent management. This issue has more of a political nature. As mentioned earlier, the frequent replacement of incumbent management is not fully justified and may do harm rather than good from the business point of view. It is mistaken to think that the management of a previous regime can be deprived of its business power, which is the political aim of such replacement exercises. It is not very likely that top managers will be available in large numbers to replace the experts of the old era. Furthermore, organic, gradual replacement is more likely to succeed than a blitz. On the other hand, incumbent management possesses insider knowledge of companies and markets that cannot be transferred or acquired from outside. If the existing management is removed, this knowledge is lost and used against the company itself if fired managers open their own business, which will usually be a strong competitor. Hungarian privatization policy was to rely on the self-interest of incumbent management rather than fight against them.

To politically neutral observers, replacement and disqualification of incumbent management seems less important than breaking with the old, paternalistic linkages. The accumulation of debt arrears was also due to surviving paternalism and opportunistic behaviour of managers. The shift of business contacts towards regular commercial links was largely enhanced. Privatization contributed to the process with the establishment of governance structures common in market economies (the sales method instead of give-away-type solu-

¹⁷ Each used a variety of performance measures. The results corroborate well with the empirical evidence of similar adjustment intensity by firms, described by Szanyi (1996) and by Belka (1993) for Poland.

¹⁸ An excellent analysis of governance problems appears in Frydman, Gray and Rapaczynski (1996).

tions). New owners certainly did not resist taking over old linkages whenever they could make use of them. Thus, we do not declare that paternalism was eliminated. In fact, such linkages can be observed in all countries. It is important here that the intensity and frequency should be limited. This was enhanced by strict enforcement of property rights and contract law through the practice of bankruptcy.

WAYS OF ASSET TRANSFER THROUGH MARKET EXIT: DOWNSIZING AND LIQUIDATION

The introduction of the new bankruptcy law caused massive macroeconomic changes. Although the law itself was not responsible for the shocks or the reasons behind corporate failures, it triggered them simultaneously in many companies. The negative microeconomic developments, coinciding in time, compounded to cause serious macroeconomic problems. The year 1992 marked the trough in the recession, when the Ministry of Finance estimated that proceedings started in that year alone affected companies producing 25 per cent of GDP and 35 per cent of exports, and employing over 800,000 people (Zsubori, 1992). There were other estimates with different figures (Holló, 1994), but the conclusions were similar: the effects of bankruptcy were extremely wide-ranging.

At first sight, the figures seem frighteningly high. What would happen to an economy of which one-third was threatened by liquidation and in a financial state to justify such a procedure? Would one-third of GDP be eliminated almost overnight? Would 800,000 people – 30 per cent of the industrial workforce – lose their jobs overnight? Fears of severe consequences were understandable, but the bankruptcy institution proved to be efficient in reducing losses to a considerably lower level. Three factors can be mentioned. First, the regula-

tions showed preference for reorganization during the first 21 months, up to September 1993, when an amendment practically closed the paths to *de jure* restructuring. This meant that the law, in the initial, most serious period, provided opportunities for sides to reach a settlement. Secondly, when formal reorganization was contained, the law still allowed liquidations to transform into reorganizations in cases where the debtor was retained as a going concern and its activity was regarded as viable. The restructuring of debtors was promoted mainly by the way liquidators were remunerated. This side of the law seriously weakened the position of creditors in liquidation proceedings, since they were no longer awarded increased control over the activity of the liquidator. But the outcome of the changes was that liquidators took over the role of formal reorganization. The latter disappeared, but wherever some production or meaningful activity by the debtor remained, the liquidators would exert themselves to maintain and consolidate that activity.¹⁹

The third factor that ameliorated the consequences of bankruptcy was action by the state. Ministries and still more the State Privatization Agency played an active role in avoiding crises and made efforts to bail out certain firms (including the so-called ‘dirty dozen’). The state as owner injected some capital. Most importantly, it mediated among the parties – who in some cases were almost exclusively representatives of the state. It was argued earlier in the paper that state intervention in bankruptcy proceedings was undesirable, especially in the early phase when proceedings are triggered. Hungarian practice generally allowed the proceedings to start, but there was intervention in several cases when important firms could not be rescued through either of the other ‘built-in’ factors. The number of firms that benefited from direct state intervention was confined to one or two dozen, so that these few exceptions did not under-

¹⁹ A detailed description of the legal changes appears in Gray *et al.* (1996).

mine the new-found credibility of economic policy.

Reorganization agreements were also promoted outside judicial proceedings. Banks were urged to settle their disputes with debtors and manage their non-performing portfolios. The law on financial institutions required banks to establish portfolio-management departments and prescribed strict prudential regulations. In addition, the state put up very considerable sums of money, to help banks to build up the necessary risk reserves and to compensate them to some extent for writing off certain parts of their debt portfolios. Bank recapitalization was in fact the strongest direct action undertaken by the Hungarian government to eliminate the liquidity problems in the economy.²⁰ The bank consolidations were not very damaging to credibility. The customers (debtors) of banks were not affected directly. Banks usually did not write off the obligations of active firms, which were rescheduled or converted into equity instead. On the other hand, the elimination of non-performing assets was enhanced. As far as banks themselves were concerned, cleaning up their portfolios was a precondition for privatization to foreign buyers. The prospect of privatization provided the safeguard against bank opportunism.

The outcome of bankruptcy proceedings also has to be gauged in terms of asset restructuring. A surge of market exits, especially in the form of liquidations, would presuppose large-scale asset restructuring, if the assets could be used economically. A major concern of pessimistic observers could be that the inheritance from the decades of the command economy: assets, created under a different socio-economic rationale, might be inappropriate under a market economy, causing huge asset wastage. In the event, losses occurred, but mainly before the stage of formal market

exit. The assets lost their value at the moment of economic transition and were scrapped in most cases, leaving behind, if anything, debt or environmental damage (another form of debt). Such debt and losses were inescapable. Failed companies left empty workshops and rusty equipment in all the transition economies, demonstrating how this inescapable type of asset loss occurred irrespective of the judicial regime for market exit, even in countries with no active bankruptcy practice.

Asset losses cannot be regarded as transfers, but they are an important constituent of restructuring – the necessary Schumpeterian process of creative destruction. They are not necessarily connected directly with bankruptcy, on which real asset transfers may depend either directly or indirectly. The direct link is most obvious in a sale of assets under a reorganization agreement or liquidation proceedings. Asset transfers, on the other hand, occurred also in day-by-day business, in some cases linked indirectly to bankruptcy, as firms sold assets to avoid bankruptcy – to gain cash and repay debt or change corporate activity and avoid a prospective long-term crisis. Without the threat function of bankruptcy, this type of asset restructuring might not have occurred or been less vigorous. The mere existence of the bankruptcy institution can therefore trigger major restructuring activity, including asset transfers.

It is hard to measure real asset restructuring of either type. Aggregate data for formal judicial reorganizations do not contain information on asset restructuring and the other, ‘normal’ type of restructuring is even less visible. The few estimates of its scale have been made by analysing panel data and empirical surveys. Some underlying characteristics of the process and a few methodological problems emerge from three such surveys.

The results of the first, covering 100 state enterprises undergoing formal restructuring (not liquidation), were published by Futó (1993). These were big in-

²⁰ A more detailed description of a bank conciliation process appears in Gray and Holle (1997) with reference to Poland. This resembles the Hungarian process in many respects.

dustrial firms that had not been randomly selected and employed 55,000 people in 1992. The first important conclusion was that their problems had arisen well before the new bankruptcy legislation. Their size (measured in total sales and employment) fell by far more than the total economy shrank between 1990 and 1992 and their labour productivity declined by 10 per cent over the same period. The size changes were caused by several factors, one important one being asset sales and another changes in organization, aimed mainly in this period at hiving off viable activities.²¹ In many cases, there was a deliberate selection of activities, carried out without strong effects from the bankruptcy institution. This resulted in asset transfers in the form of sale or asset stripping. Bankruptcy affected mainly the remaining activities that were performing worse.²² Futó (1993) also measured the effects of the market shocks that contributed to falling sales and decreasing size. Interestingly, the group of enterprises suffering the largest loss of markets (sales fell to 13 per cent in two years) did not reduce their size proportionally. Employment remained at 29 per cent. State-owned firms with big losses tended to respond with less radical downsizing than those that suffered less. Labour productivity (measured as a simple division of employment into sales) therefore fell more in the group of companies surveyed. Another interesting finding was that smaller firms were more involved in payment arrears than big ones. They accumulated much higher stocks of receivables and obligations, compared with their assets or turnover, but the two figures were in ap-

²¹ Creaming of firms in this period often resulted in spontaneous privatization, or in worse cases, asset stripping.

²² Éva Voszka did some fundamental research on spontaneous privatization and the break-up of the organizational structure of the most important 45 Hungarian firms (conglomerates). She concluded that separation of viable and unpromising activities was correct in most cases, and the outcome of the process was the survival and privatization of much of the original activity, and exit (liquidation) from unviable ones. This early separation effectively saved profitable activities from collapsing together with non viable ones (See: Voszka, 1997).

proximate equilibrium. Big firms, on the other hand, amassed relatively less debt, but the level of receivables was significantly lower. It therefore seems that big firms were more responsible for the acceleration of payment arrears than smaller ones. Furthermore, the problem in the second case could not be resolved by a clearing arrangement, mainly because of the big firms. The claims of smaller firms, at the end of the chain, were primarily against the big firms, so that they could not be collected effectively. Futó (1993) went on to analyse the liquidity position of the firms in the survey. This identified three groups of firms. The first group was affected mainly by market losses, while another suffered more from accumulated debt. Relatively better liquidity figures were produced by companies able to reduce their stock of debt through asset sales that strongly reduced their size. Less liquid firms also showed marked declines in production and exports, but to a lesser extent. Between the extremes, there were companies with average liquidity and indebtedness levels. Their sales remained on the highest level (especially exports), and according to Futó, stood better chances of survival.

Novák and Szanyi (1995) constructed a panel of 150 large industrial firms, from data extracted from the lists of the biggest industrial firms published by the Hungarian business newspaper *Figyelő* for the years 1989–93. The panel included firms that did not undergo liquidation in the period observed and were not subject to major organizational changes either, which meant it could be used to measure the real downsizing of these firms before and after 1992. There was a steady decline in both output (sales) and employment. The former was especially dramatic – almost 40 per cent in 1991, the year before the introduction of the new bankruptcy law – whereas there was only 5 per cent decline in sales thereafter (1992–3). The reduction of employment was much steadier and not on the same scale. Over the whole period, sales fell back to 40 per cent of the 1989 level and employment to 50 per cent. The authors

consider that employment was reduced sufficiently compared to sales development: a minimum level of basic staff needed to remain in the hope that sales would recover. It was also possible to distinguish different ownership and size groups in the sample. It was concluded that downsizing was similarly deep in all ownership groups, but privatized foreign firms recovered more quickly and tended to scale back employment more radically than state-owned firms did. They did so rapidly, while state-owned firms made reductions more slowly, although the eventual reductions in size were similar. Hungarian-owned privatized firms behaved more like state-owned firms, mainly because they had been following similar policies before privatization. The most important conclusion was that firms not undergoing liquidation or major organizational changes went in for very strong downsizing and reorganization, similar in scale to what happened in the economy as a whole. Very significant asset restructuring occurred in firms without formal bankruptcy, even before the new bankruptcy law began to bite.

The third survey, described by Gray *et al.* (1996), was aimed at the process of formal bankruptcy proceedings, based on a sample of 117 observations. Details of reorganization agreements were also analysed, where potential asset transfers were detected. Since the survey was conducted in 1994–5, very few completed liquidations occurred in the sample, so that little information was provided about asset transfers of this type. The first finding of interest here was that the proceedings tended to orient firms showing better financial measures towards reorganization and weaker firms towards liquidation. The chance of reorganization went to firms with better chances of survival. In this respect, the law was efficient. Another important observation was that the process of liquidation was very slow. The first assets were not sold until an average of 13 months after the proceedings started. Asset transfers were being blocked by several factors. One group of obstacles had judicial nature: asset sales

could not be started until legal disputes had been settled. The other had a regulatory character. Although remuneration of liquidators depended on the incomes realized in asset sales, general practice showed a preference for selling firms as a going concern, to gain potentially higher revenues, even if this occurred only much later. This might be disadvantageous to creditors, but their influence and control over the liquidators was limited. A 1995 amendment of the law increased such influence, but gave liquidators a financial stake in sustaining firms as a going concern. Consequently, a relatively small proportion of assets was sold. On the other hand, the law left some loopholes in the proceedings. Deliberate tactics by debtors could effectively hold back the proceedings, most importantly the appointment of the liquidator. On average, liquidators were appointed only 10 months after the filing was made. This long period provided an opportunity for interested parties, debtors and creditors alike, to reach an out-of-court settlement, which was fine. But the opportunity could also be misused and parties indulge in asset stripping or violation of the absolute priority rule.²³ Such tactics frequently resulted in covert transfers of assets. The survey also analysed the reorganization agreements. Most involved financial restructuring, write-offs of debt principal, extension of the maturity of debt, and reductions in interest. Only a few involved financial restructuring of formal asset transfers: debt to equity swaps or extension of new credit. Operational reorganizations were even less significant. Reductions in employment continued in 60 per cent of the agreements, but asset sales were planned only a surprisingly low 30 per cent of

²³ Absolute priority rules are prevalent in bankruptcy legislation, for regulating the meeting of claims according to a system of priorities between claimants. Groups of similarly treated claimants are distinguished (*e.g.* secured creditors with a lien on physical assets, government tax and social-security claims, unpaid wages to employees, claims of unsecured creditors, bondholders, claims of trade creditors, and claims of shareholders and other owners). Each category is settled according to the established order of priority before the claims of the next class.

cases.²⁴ Purchases of new assets, equipment, etc. hardly featured in the reorganization plans. Questions on what really happened after the plan was accepted yielded similar results. Operational reorganization usually meant a reduction in employment (71 per cent of cases), and sales of assets (40 per cent).

An important conclusion can be drawn here. Empirical evidence suggests that formal bankruptcy proceedings did not result in massive waves of market exit. Gray *et al.* (1996) concluded that the majority of the sample firms that underwent reorganization or liquidation were still active two years after filing. This was especially true for larger companies. In cases where liquidation was started against companies that had ceased to function as a going concern, market exit happened before the filing. Market exit was not triggered by the law in these cases. This emphasizes the importance of non-bankruptcy cases in large-scale transfers of assets.

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²⁴ It is a different matter to say whether major assets were actually sold. The survey asked only about intended, not executed asset sales. Debtors might have had no incentive to include necessary asset sales into the reorganization plan, if that would limit the size of the debtor's assets available as a last security for creditors.

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