TITLE: INSTITUTIONAL CHANGE AND MANAGERIAL MOBILITY IN HUNGARY AND THE CZECH REPUBLIC

AUTHOR: AKOS RONA-TAS, University of California, San Diego

THE NATIONAL COUNCIL FOR SOVIET AND EAST EUROPEAN RESEARCH

TITLE VIII PROGRAM

1755 Massachusetts Avenue, N.W.
Washington, D.C. 20036
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1 The work leading to this report was supported in part by contract funds provided by the National Council for Soviet and East European Research, made available by the U. S. Department of State under Title VIII (the Soviet-Eastern European Research and Training Act of 1983, as amended). The analysis and interpretations contained in the report are those of the author(s).
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INSTITUTIONAL CHANGE AND MANAGERIAL MOBILITY IN HUNGARY AND THE CZECH REPUBLIC

AKOS RONA-TAS
University of California, San Diego

Abstract
Research conducted in 20 Czech and 20 Hungarian medium and large enterprises show that in both countries CEOs are mostly recruited internally, and top managers and their companies are strongly linked to the point that one cannot speak of a market for top managers. Top managers are hard to replace because they accumulate personal ties and 'personal' knowledge that comes only with on the job experience. The most likely replacement of any CEO is his deputy, whom he selected.

The paper gives a short overview of the company restructuring which has proceeded in the two countries. Downsizing was more radical in Hungary, but there was more of it in the Czech Republic than low unemployment figures would lead us to believe. Czech companies can rely more on bank loans for new investment than their Hungarian counterparts. Work organization has changed only if new technology was introduced, but high unemployment in Hungary raised labor discipline. Finally, both Czech and Hungarian companies were quite successful in finding new markets in the developed world. Many of these changes happened before privatization.

Managers had a stronger position before 1990 in Hungary and thus had more influence over the formal rules of privatization. After 1991, however, Czech managers gained more autonomy and devised various creative arrangements to keep their freedom. Organizational change comes slowest to companies where managers bought out their firm and comes fastest to enterprises founded or bought by foreign investors.

Introduction
What is the relationship between institutional change and elite mobility? To what extent does privatization influence changes in top personnel? And what is the connection between changes in top personnel and economic restructuring? Is a labor market for top managers emerging?

I have investigated 20 large and medium sized companies in the Czech Republic and 20 similar companies in Hungary. I have visited 6 state owned companies, 28 privatized companies half of which had foreign owners, and 6 new startups. In each company, I have conducted an in-depth interview with the CEO, took a tour of the company's premises and gathered other information about the company from annual reports, business registers, newspapers and other sources.

The Absence of Managerial Markets: The Institutional and Organizational Embeddedness of Managerial Carriers
Careers of CEOs show that the market for managers is very weak, because in both countries managers are strongly tied to their companies and these ties are reinforced by their personal
knowledge -- an unarticulated knowledge that comes only with experience\(^1\) -- and social networks.\(^2\) Most of the top managers are recruited internally, from within the company, even though most vacant top jobs are formally open to outside competitors. The typical Hungarian manager started his career in the enterprise that he manages now. Half of them had worked for a single company for their entire lives and most of the rest had only one other job. (For managers of newly founded companies, there are at least two previous employers.) In the Czech Republic, managers had somewhat more eventful careers, but only because some were demoted after 1968 for political reasons. Even these persecuted people were back on their career tracks by the late 1980s. It was the politics and not economic forces that moved these managers around.

The typical manager graduated with some technical degree that makes him a specialist in a particular production process. As a result, he can choose only from a few companies that fit his specialization. Even if he received a degree in business, rather than in engineering, his training was highly specialized.

Managers, therefore, have a very strong attachment and loyalty to their companies and often strongly identify with it. Their bonds in certain cases have roots even reaching back to their parents. In some instances, one of the managers' parents worked for the same company or for a similar company in the same industry.

Newly founded companies should be different from privatized ones, since there should be no pre-existing link between managers and organization. But often they are not that dissimilar. Newly founded companies are not emerging out of thin air. In many cases they come about because managers of state companies move certain operations out of that company into a new enterprise they have founded. This is de facto privatization: privatization of the markets and/or the work organization of the state company. These invisible assets can often be used exactly as inventory or capital. For instance, if one privatized his company's clientele with their orders for certain services or goods, those orders could be used as 'collateral' in obtaining bank credit. The same way, when the manager of a state company takes his best workers and transfers them into his private company, he appropriates human capital, a large part of which developed through on the job experience at the state company. Here not the entire organization is what "stuck" to managers, but only a part of it recast as a new firm.


The strong ties between manager and company are partially explained by 'personal knowledge' accumulated on the job, that seems to make it difficult for outsiders to break in at the top. The manager knows where the files are, how to get extra supplies if necessary, which work unit is reliable and which cannot be counted on, what violations of a contract with other firms are acceptable and which will lead to retribution. Much of this personal knowledge is difficult to articulate and gets manifested in the judgment of the manager. The difficulty of obtaining this personal or practical knowledge is best illustrated, when someone with extensive understanding of the area but no personal knowledge of the company takes over. As one economist whose research specialized in finance and who later joined a newly established bank put it: “In the beginning everything was very hard... I had theoretical knowledge, but I had to learn practical knowledge by doing.” Another manager, whose previous job was to oversee his company as a ministry official described it this way: “I knew this company well, but I still had to learn the company culture and the personal relations.”

With personal knowledge come a set of social relations that also play an important role in the stability of managerial careers. CEOs claim to know personally most or many of their employees. Even in firms of several thousand employees communication happens through informal, verbal instructions.

Personal contacts are very important in contracting suppliers and distributors. One manager explained it this way: “Partnership (in obtaining price information) is very important. Under socialism partnership often grew into friendship. These are long term relationships, where personal contacts are very important.” Trust plays a central role. If one party violates a written contract it takes about three years in both countries to push litigation through the courts and receive legal redress. While not all important personal contacts are the CEO’s and some may belong to one of his subordinates, foreign relations and bank contacts always involve the top manager.

CEOs report that friends from college provide important professional and business ties. Since most of the CEOs have technical degrees, their networks link them to people in the same segment of their industry, which, again, limits their mobility. This is further aggravated by the fact that both economies are small and industries under socialism were highly concentrated in a handful of enterprises.

A different network of relationships exists with "Comrades," since the majority of the CEOs in both countries were members of the Communist Party. These connections are very valuable.

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3Interview #11.
4Interview #20.
5Interview #21.
because they usually reach into the state bureaucracy. Even governments with strong anti-Communist agendas could not replace more than the top of the state bureaucracy. The Czech lustration law did not affect the state bureaucracy. It was aimed at a handful of former high ranking Communist functionaries and excluded them only from top political offices. Middle and lower bureaucrats were left alone. They were as difficult to replace as managers because they also possess personal knowledge and social networks.

How Managers Move

Managers move either in response to political pressure or when owners -- state or private -- with concentrated ownership rights force them to.

In Hungary, most managers currently in charge were already in the top position in 1989 and hung onto it successfully, or they were promoted upon the retirement of their bosses around 1990. The boss was usually close to retirement age, and the promotion would have happened anyway a few years later. This is not to say that CEOs were never fired, but this was a rare event in Hungary in the first years of the post-Communist transformation. Those managers who were fired in this early stage fell victim to the Hungarian center right government’s zeal to put its own people in charge of the handful of strategically important companies, over which it had direct jurisdiction. Most companies were not under direct government control by the time communism fell.

In the next phase, starting in 1991, many companies were privatized, and whenever they were purchased by a new foreigner, the new owner would fire the top manager and bring in his own people. Cleaning up top management was always a high priority for foreign owners. The clean-up happened in an incremental fashion, whereby foreign managers were brought in along with the foreign CEO, but some members of the old management were also kept to ensure continuity. The house cleaning was then carried out by the two groups jointly, with the foreigners in command. During this period the foreign team decided who was worth keeping from the already reduced old guard and, after a few years, they promoted one of the locals they deemed most able to the position of the CEO, usually following proper training abroad.

Other Hungarian managers became owners themselves. In a chain of events, often called ‘spontaneous privatization,’ managers successfully split off some part of their state companies, often using employee ownership schemes. In some cases, the owner-manager shared ownership with some foreign investor. A fourth of my Hungarian (and a third of my Czech) sample were managers with controlling ownership interest in their companies.

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7The Communists learnt this very same lesson after 1945 when they took over the state apparatuses in East Europe. See Akos Rona-Tas, Great Surprise of the Small Transformation: Demise of Communism and Rise of the Private Sector in Hungary. Ann Arbor, Mi.: The University of Michigan Press (In Press).

8Akos Rona-Tas, Great Surprise of the Small Transformation.
The typical scenario in the Czech Republic was different. In the spring of 1990, responding to pressure from local activists, the previous boss -- usually a Communist cadre -- was fired or demoted. His deputy, more popular but invariably a party member himself, was then promoted to head the company. If the company was subsequently privatized by the voucher method -- as most were -- the story ended there. The manager stayed. The tens of thousands of small investors could not challenge him. Investment funds, which concentrated the shares, could have acted as real owners but did not, as they started out with widely spread portfolios and little expertise. Portfolios are now simpler and expertise is building and it remains to be seen if Czech investment funds are willing to assume a more active role.

If the company was sold to a foreign investor or was not privatized at all, the Czech manager faced a strong owner. The state as owner intervened only in cases of gross mismanagement. In such cases political outcry in the media or in parliament started the procedure, at the end of which the manager was fired and a new one was appointed. Foreign investors took a more proactive role. They kept the CEO if they were satisfied with his performance. If the owner was dissatisfied, the manager still rarely met the fate of his Hungarian counterpart. He was not fired, instead, he was demoted, usually to the rank of technical director. This solution followed the most frequently voiced complaint against old CEOs -- they know a lot about production, but too little about finances and marketing.

The reason why old Czech CEOs were more likely than their Hungarian colleagues to stay with their companies once the new owner decided to replace them can be found in the different role managers had in the two economies before the fall of Communism. The Hungarian Communist government gave a large amount of autonomy to managers and since 1984 they were very powerful in their companies. In the Czech Republic (then Czechoslovakia) the state kept a tighter rein on managers and did not allow them to grow too strong within their enterprise. New owners of Hungarian companies, thus were facing powerful directors, who having been used to a weak owner -- the Hungarian state -- were (or were expected to be) insubordinate. New Czech owners, on the other hand, initially did not have this problem. One result of voucher privatization in the Czech Republic, however, was an increase in managerial discretion. New owners, such as some investment funds, which want to assert their ownership rights are now encountering a situation similar to what existed in Hungary six years ago. Thus whenever new owners with a sufficiently large ownership share take over Czech companies privatized with vouchers, their first move is to fire the top manager and promote one of his deputies.

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How Does Restructuring Happen?

Downsizing

Restructuring happens to a lesser extent as a result of privatization. The bulk of restructuring in both countries took place before privatization. There were two main factors facilitating restructuring in both countries. The first one was the collapse of COMECON, which dealt an enormous blow to companies, and which happened in 1991, before privatization was in full swing. Companies had to adjust to their radically different environment. The second factor was the anticipation of privatization. In Hungary the state carried out downsizing to make the company more attractive to prospective buyers. In the Czech Republic the same happened whenever the state decided that the company would be sold rather than privatized through vouchers, or when the company was in such bad shape that even voucher privatization was impossible.

Despite very low unemployment figures in the Czech Republic, Czech companies did not shy away from downsizing. They tended to cut their work force somewhat less than Hungarian firms did, but the reduction was still substantial. (According to one labor force study the rate of exit from jobs in the Czech Republic is not significantly different from other countries, but the rate of entry into new jobs is much higher. 10)

Foreign owners are unlikely to cut their work force, mostly because the state had already done so, but also because they would not have purchased the firm unless they thought it had good prospects to grow.

New Investment

Most Czech companies invest by borrowing from domestic banks. Although the Prague stock exchange is the largest in the region with 1,635 companies registered, Czech firms rarely raise money through the stock market. Foreign owned companies by-pass domestic lenders and deal with their own, foreign lending institutions. Borrowing presents a very different picture in the Czech Republic and Hungary. In the Czech Republic, inflation is below 10 percent and interest rates are commensurate. There is general disagreement over the health of the Czech banking sector, 11 yet as of 1995-6 companies were able to finance new projects from bank loans. In almost all large companies there has been some larger investment project in the last two to three years.

In Hungary borrowers face greater difficulties. The stock market is not an option there either. It has less than 40 companies registered. With interest rates twice the Czech ones, Hungarian companies cannot afford investment loans. The situation is even more severe whenever the -- usually domestic -- owner had to borrow money to buy the company. In those cases paying off the loan taken out to pay the sale price makes new investment projects next to impossible. Several Hungarian

10 This data are from ongoing research by Daniel Munich at CERGE-EI in Prague.
11 Eight small banks have collapsed so far this year in the Czech Republic.
CEOs volunteered the opinion that one of the keys to success is the ability to avoid bank loans, a comment I have never encountered in the Czech Republic. Hungarian banks are also more interested in lending to the government on high yielding bonds than risking loans to companies. Thus, if there is any new investment, it comes out of company profits, a practice encouraged by the Hungarian tax code.

**New Work Organization**

Organizational innovation is also part of restructuring. Invariably, companies create or strengthen their marketing departments and cut other white collar positions. Reorganization of production happens only as a result of the introduction of new technology, though some rearrangement of responsibilities often follows downsizing.

Firms with foreign owners take over much of the philosophy and organization of the multinational, though the final result is always a compromise. Because changing organizational culture is a difficult process, foreign investors often prefer open field projects over buying state companies up for privatization.

Despite little organizational change in production, Hungarian managers and workers agreed that labor discipline improved considerably. In the Czech Republic few believed much has changed in this respect. Hungarian workers are better behaved because the risk of being fired and not finding another comparable job is high in an economy where unemployment is in the double digits.

Trade unions are present in every state and privatized firm, but never in new start-ups. Unions, however, are rarely taken seriously except by multinationals, who often sign an agreement to keep unions when they purchase the company. Multinationals are more attentive to unions also because they project their experiences with strong German, Austrian or even US organized labor onto their much weaker Czech and Hungarian counterparts. This still does not give unions much of a clout, though a few managers did think that the union (or unions) in their company was too strong.

**New Markets**

Both Czech and Hungarian companies made the transition from undemanding and monopolistic COMECON markets to exacting and competitive western markets. This move was more radical in the Czech case because Hungary already had considerable Western exports by 1989. But this shift

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13 The multinationals often follow their own, habitual ways of attending to labor issues even when it is economically irrational. One company of American ownership discontinued all fringe benefits, such as giving away company products, providing subsidized vacations, and paying for bus passes. Instead, it folded everything into a salary supplement. With payroll taxes around 50%, this was much more costly, but as the manager explained, “this method is clearer and therefore there is less room for abuse.” (Interview #33).
was not painless for Hungary, either. The overall westward openness of the Hungarian economy masked great differences among industries. Certain branches, such as steel and electronic goods manufacturing, were completely reliant on COMECON markets. Others subsidized their western exports by their profit margins selling to other socialist countries. These industries suffered difficult times.

Multinationals often facilitated this east-to-west switch by hooking their Hungarian or Czech companies into their own distribution system. But in certain cases foreign owners were primarily interested in buying the domestic market. Even then, foreign owners raised the quality of the product and improved packaging. As they also increased their prices they shifted these goods into a different market segment on the domestic market moving familiar products out of reach for many people.

Managers and Institutional Change

Organizational change as I have argued had only a modest effect on managerial mobility, which can be summed up this way: early promotion for deputies. But did managerial mobility or permanence have any impact on institutional and organizational change?

Managers' Role in Setting the Formal Rules of Privatization

Because managers and companies are hard to decouple, managers will try to do whatever they can to influence privatization of their own companies. Managers in Hungary played a more important role in crafting the written rules of privatization than they did in the Czech Republic. Managers started from different positions in 1989 in the two countries. In Hungary, managers had great autonomy, they were more attuned to market mechanisms, they had contacts to the West and they were politically organized. The center right government, which considered them to be part of the defeated Communist regime, fought against them with little success. They were difficult to remove. Initially the political leadership did everything it could to take privatization out of the hands of managers, but soon had to realize that without their cooperation privatization will never happen. Thus the Hungarian government decided to introduce self-privatization, whereby management was entrusted with finding a way of privatizing the company. The strength of managers to stay prevented the government to ignore their interests.

In the Czech case voucher privatization was the method of choice. The Czech government did not consult managers who were much easier to remove than their Hungarian colleagues, and it bypassed them with the voucher scheme. As a result, managers had much less opportunity for splitting off and appropriating valuable pieces of their enterprises. In the later stages, management buy-outs were much less frequent than they were in Hungary.

Managers' Role in Setting the Informal Rules of Privatization

Privatization through sales gave Hungarian managers a chance to become owners or to have some say as to who their new owners would be. Becoming an owner was not always the best
strategy for managers. In many instances selling the company to a multinational that pays its
managers well, holds up the promise of an international career and which has the resources to turn
the company around was preferable to buying the company on high interest loans. Once the company
was sold, the manager either became an owner or became a strictly supervised agent of the new
owner. In case of companies that remained in state hands, managers kept more discretion. Voucher
privatization excluded managers from becoming de jure owners of their companies, but it created an
ownership structure, that was highly fragmented. Czech managers, thus were left with all the
ownership rights that they could exercise not by right but by default.

While Hungarian managers were more successful at influencing the written rules of
privatization, Czech managers had more autonomy in making up informal rules after the privatization
pertaining to ownership. One such creation is the ownership loop. Managers create an investment
company. This investment company sets up an investment fund, which collects shares from tens of
thousands of small investors. This investment fund buys into the company. As a result, the manager
gains de facto ownership rights, since his appointee who should be representing the micro-investors
of the investment fund will act as an agent of the manager.

Many of these ownership loops were created first by company managers of foreign trade
companies. These managers had developed autonomy and market skills already under Communism as
they had to work on merciless foreign markets.

Managers and Organizational Change
Organizational change comes slowest in companies that managers bought out for themselves.
The manager is often deeply in debt, which makes new investment into the company very unlikely.
The manager often buys out the company with his colleagues. The collective ownership impedes
making difficult decisions, especially when it concerns closing down certain operations belonging to
one of the co-owners. Finally, if the managers bought their company early, they might have bet on
the wrong horse. The parts of a company most profitable under socialism are not necessarily the
ones most valuable in a market economy.

Organizational change is most rapid when the company is acquired by foreign owners. Foreign
owners not only bring resources, but to some extent they are able to decouple managers and
companies and widen the pool of candidates for the top jobs. By bringing in their own people who
worked in a similar enterprise belonging to the multinational elsewhere, they are able to put in
charge experienced people, who are not imbued with the old ways of the company. Foreign
managers have no networks in the country and in many respects this is a clear handicap. Foreign
managers are aware of that, especially if they face a language barrier as well. These expatriates, on
the other hand, are well connected toward the mother company and foreign business partners. Since
multinationals rarely depend on Czech and Hungarian companies for supplies and services and have
their own distributors, domestic ties carry less importance. Social networks, however, are not always
enabling. They can be disabling as well, since they carry personal obligations and restrictive norms. Thus expatriates have the advantage of not being shackled by obligations and norms that might interfere with carrying out certain unpleasant measures. Knowing that they will eventually leave the country, they can act like the lone heroes of Western movies: riding into a strange town, setting things right and then riding out of town into the sunset, leaving behind justice and a few corpses.

Conclusion

There are several “head hunter” firms who specialize finding fresh managerial talent. Their biggest customers are multinationals, who fill second tier positions with their help. They almost never recruit CEOs. Neither the Czech Republic nor Hungary has developed a managerial labor market. The reason is that companies and managers are hard to separate. The lack of personal knowledge and proper social networks make it very difficult for outsiders to enter a company at the very top. Moreover, the small size of both countries’ economy, their high centralization, and the lack of geographical mobility make elite mobility through the market even more difficult.

Both the formal and the informal rules of privatization were strongly influenced by managers whenever they enjoyed strong incumbency.

The strong staying power of managers, however, does not disable restructuring. It seems that managers are only one of the many forces influencing the course of change in the company. Yet, once we account for other major factors, such as market pressures, availability of credit and technology, etc., there is an important margin, where managerial qualities matter. Can an open market for CEOs exist in Central Europe?

The evidence seems to suggest a negative answer. In most cases, insiders stay or get promoted to manage the firm. When foreign owners take over, the person they put in charge may be an outsider from the company’s perspective, but he is an insider from the larger organizational unit of the multinational. Multinationals promote their own people to take the new position, they never advertise and hire from outside. Even in this event, the new CEO needs the help of the old guard. Moreover, whenever a domestic outsider becomes manager or owner/manager of a firm, the firm rarely does well. Here the causal link, however, may be in reverse. Poorly performing, weak and mismanaged firms, usually still before privatization, may need and attract new outside CEOs. and it is that weakness which brings down firms, not inexperienced and ill-connected new CEOs.

Should there be open competitions for CEO positions? Yes. Competition forces insiders to articulate new programs for their companies and may help the best insider to get the job. The possible candidacy of outsiders may make the competition among insiders more serious.