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DISCUSSION PAPERS

MT-DP – 2008/18

CODES OF GOOD GOVERNANCE IN HUNGARY

ZSOLT BEDO - EVA OZSVALD

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Codes of Good Governance in Hungary

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Codes of Good Governance in Hungary

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Abstract

The purpose of the paper is to account for the short history of the soft law regulation of corporate conduct on the Budapest Stock Exchange (BSE). In theory, voluntary codes of good governance are expected to improve the deficiencies of the existing mechanisms of corporate governance. In case of the Hungarian public companies the most important corporate governance problems are those related to the fragile safeguards of the interests of minority shareholders and to the lack of incentives for a much higher degree of transparency and disclosure. It is these two sets of issues on which the present analysis concentrates. The empirical core of the paper assesses the quality of information to be gained from the corporate governance reports of listed companies on the BSE. In order to discover links between the quality of information and firm characteristics we categorized the declarations based on their adequacy and applied binary regression analysis. We found inverse relationship between ownership concentration and the quality of information, while the higher liquidity of shares enhanced the adequacy of declarations.

Keywords: Corporate governance, company law, voluntary codes of governance

JEL: G18, G34, K22, P34

Felelős Társaságirányítási Ajánlás: új szabályozási eszköz a Budapesti Értéktőzsdén

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Összefoglaló

A nyilvános részvénytársaságok számára törvény írja elő, hogy évente ún. corporate governance jelentést készítsenek a BÉT ajánlásainak (FTA) figyelembe vételével. Az EU-országokban szokásos szabályozást szorosan követő ajánlások elfogadása a vállalatok számára nem kötelező, az eltérést azonban a jelentésben indokolni kell (a „comply or explain” elv alkalmazása.) Jelen tanulmány az FTA bevezetésének körülményeit és működésének eddigi tapasztalatait foglalja össze, továbbá empirikusan vizsgálja a jelentések hatékonyságának egyik legfontosabb szempontját, az átláthatóság javulását.

Az originális empirikus kutatás célja a nyilvános részvénytársaságok által 2007. évben kiadott felelős társaságirányítási jelentések információtartalmának értékelése volt, azaz annak megállapítása, hogy a jelentések képesek-e csökkenteni a tulajdonosok és a vállalati felsővezetés között fennálló információs aszimmetriát. A nyilatkozatokat a fenti célnak való megfelelés alapján osztályoztuk, s bináris regresszió alkalmazásával kerestük az információ minősége és a vállalati tulajdonságok közötti összefüggést. Azt találtuk, hogy míg az erősödő tulajdonosi koncentráció csökkenti, a növekvő részvénylikviditás javítja a nyilatkozatokból kinyerhető, a befektetési döntésekhez elvileg szükséges információ minőségét.

Tárgyszavak: Vállalatirányítás, társasági törvény, felelős társaságirányítási ajánlás

JEL: G18, G34, K22, P34

1. INTRODUCTION

Back in the middle of the 1990s codes of good governance were in effect only in a few countries (mostly those belonging to the Anglo-Saxon legal system). Since then the popularity of codes has risen sharply around the world, especially after 1998. Today, there are more than sixty countries (including most of the EU member states) on the country list of codes registered at the European Corporate Governance Institute¹. The increased interest in this type of soft law regulation has been connected to the globalization of capital markets, the increased appreciation of quality governance in the eyes of investors and the proliferation of the shareholder value paradigm in general. The proactive policies of international organization and supra-national bodies contributed significantly to the speed of the diffusion of codes of good governance which show a remarkable similarity across countries, at least as far as their formal content is concerned.

Hungary is a relative latecomer among the users of codes of corporate governance. The present codes (updated from its first, 2004 version) have been implemented by the Budapest Stock Exchange earlier this year. The codes were adopted and modified mainly as a result of the pressure from the Commission of the EU. The role of domestic market players was much more modest and they have not contributed significantly to the compilation of codes by initiating the inclusion of country-specific recommendations.

One of the *raison d'être* of the codes is to improve the deficiencies of the existing mechanisms of corporate governance. The aim of this paper is to examine how this works under Hungarian circumstances. The main feature of the Hungarian stock market is the high degree of ownership concentration of the listed companies. It follows from the dominance of controlling shareholders that the most important corporate governance problems are those related to the fragile safeguards of the interests of minority shareholders and to the lack of incentives for a much higher degree of transparency and disclosure. It is these two sets of issues on which we will concentrate when analysing the codes of good governance in practice.

The next section of the paper gives a short account of Hungary's transition from a planned to market economy in the framework of which the concept of corporate governance started to slowly emerge. The third section deals with the statutory regulation of corporate governance by the description of the relevant chapter of the modernized Company Law. In section 4 we turn to the Budapest Stock Exchange, the responsible body for the codes of good governance the implementation and the content of which will be subsequently analysed. In section 5 we will consider the consequences of the nature of the trigger of the Hungarian

¹ www.ecgi.org From this website full text versions of codes of corporate governance of different countries, including Hungary can be downloaded.

codes and show the degree of convergence with the EU guidelines. Section 6 contains the results of our empirical analysis which present original inferential statistical information on the quality of the disclosure of companies' compliance statements in relation with the codes. Section 7 concludes.

2. HISTORICAL AND REGULATORY ANTECEDENTS

Hungary's modern business history began in the early 1990s. The label of late-comer is justified: at the time when the first influential code of good corporate governance (the Cadbury Code, 1992) appeared in the European Union, the Budapest Stock Exchange had just re-opened with less than a half dozen public companies and Hungary's privatization program was still in its starting phase. Subsequently, the pace of institution-building and regulatory reforms accelerated, and by the end of the decade Hungary had successfully completed her transition to a well-functioning market economy. Yet the concept of corporate governance was slow to spread, due primarily to reasons of a historical and cultural nature. During the era of state socialism, characterized by central planning, state ownership and the corresponding internal organizational structure of companies, corporate governance, as understood in market economy terms, was completely missing both in the legal and economic sense.

The turnaround in the field of legislation came in 1988 with the promulgation of a modernized company law, which was the first important step in breaking with the state socialist past in the enterprise sector and paving the way towards an economy based on private ownership. This law served its purpose well, and it took nine more years before the next substantial amendment took place. The amended 1997 Company Law, however, still did not explicitly address the issue of corporate governance of public joint stock companies.

The key reform in the transition of all Central Eastern European countries was privatization. A survey of the literature reveals that corporate governance in Central Eastern Europe was largely determined by the chosen strategy of privatization and the resulting ownership structure of both publicly and privately held companies. In the case of Hungary, the primary method of privatization was direct sales of enterprises to strategic (mainly foreign) investors, which led to concentrated ownership and a general antagonism between controlling owners and minority shareholders.

Even in the second half of the 1990s, during the height of privatization and the promising boom of the Budapest Stock Exchange, the need for improving and better understanding

corporate governance was not seriously addressed. Questions concerning the protection of shareholder investments or the acceptability of unequal relationships among different types of owners were hardly ever raised. As the theory of corporate governance would predict, the systematic neglect of corporate governance in Hungary has contributed to the strengthening of a bank-based bias in corporate finance and the underdevelopment of capital markets in comparison with other sectors of the economy.

It is due primarily to external factors that awareness of the importance of good governance took hold in Hungary by the new millennium. Hungary's preparation for accession to the European Union coincided with the Commission's efforts to promote better corporate governance principles and to harmonize member state regulation in this field. The 1997 amendment of the Hungarian Company law was done in accordance with the *acquis communautaire*. Similarly, the Capital Market Act of 2002 brought regulation in this area in line with the respective EU laws. The Accounting Law has also caught up with western standards.

3. HARMONIZATION OF THE COMPANY LAW

The process of the Europeanization and thus the modernization of the Hungarian legal system did not lose momentum even after Hungary achieved full membership status in the European Union. The Commission of the EU keeps a strong eye on the on-going institution-building of the new member states to which Hungary belongs and the requirements of harmonization are a priority in their new lawmaking, amendments or fine-tuning of the existing regulations.

The 2006 amendment of the Law on Business Associations (Act IV. of 2006. the "Company Law") clearly reflects that the source of changes is to be found in the EU directives in the first place. From the viewpoint of the topic of this essay the most important improvements in the Company Law can be summarized as follows. A notable feature of changes is that the emphasis on the protection of interests of creditors, shareholders and minority shareholders in particular has been enhanced. Distinction was drawn between private and public companies with different rules applying for each group. The shareholders of public limited companies now have the choice to initiate the establishment of the Anglo-Saxon type unitary board system or stay with the traditional two-tier board structure. The act deals extensively with the role of the board and prescribes that the majority of the board shall be made up of independent directors. It has been made clear that independent directors cannot be engaged in executive roles. Public limited companies are required to set up an audit board consisting of minimum three members from the board of directors elected by the general meeting.

The new company law unlike its predecessor has an explicit reference to the rules of corporate governance. It states that listed companies are guided by the Recommendations of the Budapest Stock Exchange for sound governance. They must provide an annual compliance report which has to be approved by the shareholders. As a next step the law prescribes that the report be posted on the official website of the company.

The general opinion is that the provisions the new Hungarian Company Law are up to the levels of internationally recognized standards. Laws on the book, however, are just one part of the story. Research (Pistor, Raiser & Gelfer, 2000) has drawn attention to the fact that it is the effectiveness of the implementation of regulations, legal enforcement and the perception of legality where the real problems in the creation of efficient business environment and developed capital markets in CEEs, including Hungary start. A deeper examination of the persistent gap between regulations on the book on the one hand and the respect and enforcement of law on the other, would lead us to inquiries into the path-dependent nature of the evolution of legality and its cultural determinants. The discussion of these complex issues however, is beyond the scope of the present paper.

4. CORPORATE GOVERNANCE RECOMMENDATIONS

The first corporate governance codes were introduced in the Budapest Stock Exchange in 2004. From 2008 they were replaced by an amended version and it is this latter document on which our present analysis focuses. The official name of this “soft law” is Corporate Governance Recommendations of the Budapest Stock Exchange to which we will refer as “Recommendations”, “CGR”, or “Code” interchangeably throughout this paper. It should be noted that principle-based, voluntary codes are an innovation in the Hungarian regulatory system.

Recommendations are closely connected with the new Company Law previously described. There are some overlaps but the Code mostly covers issues not dealt with in the Company Law. Beside the harmonization requirements with the new Company Law the other decisive source of the updating of the Hungarian code was the then recent recommendations of the European Commission, namely the recommendations on an appropriate regime for the remuneration of directors of listed companies (2004/913/EC) and on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

The chapters of the CGR similarly to other national codes cover shareholders' rights and treatment of shareholders, responsibilities of the management and the boards, the establishment and the duties of committees, and the principles and procedures of disclosure.

Transparency is crucial to the perception of the company, especially when trust and credibility is in need of as much strengthening as it is in Hungary. This is why we regard statutory disclosure as a first indispensable step in the improvement of corporate governance on the BSE. In their annual reports listed companies must take stock of their corporate governance policies and internal control practices. Further, they are expected to provide information as to what extent they follow the recommendations of the BSE. The method applied there is based on the "comply or explain" principle. If the company chooses not to follow the given recommendation or deviates from it in a certain manner, an explanation for the reasons should be provided. The Code contains also suggestions, the non-compliance with which does not need detailed explanation.

If not the letter, the spirit of the Code dictates that the filling of the template be not a box-ticking exercise for the management but a means of providing true and relevant information for the assessment of the quality of different aspects of a given company's governance. Our empirical research which we will present in the later part of the paper shows that many companies do not care enough about the quality and relevance of the information they disclose. This we regard as an unresolved problem of the Hungarian CGR practice.

5. THE TRIGGER AND THE DEGREE OF CONVERGENCE

In the integrated global capital market not only companies but countries, stock exchanges, and professional bodies compete for capital (Gordon, Roe 2004) by implementing safeguards that prevent expropriation by agents (Fama, Jensen 1983). The emergence of codes of corporate governance on national level is to eliminate uncertainty for investors, by providing them detailed information on the internal control mechanism of the listed companies. The presence of a code, however, is one thing; the other is its efficiency in enhancing the flow of accurate and timely information in the interest of shareholders. The fulfillment of this goal is dependent on a number of factors, including the origin of the triggering force.

Aguilera and Cuervo-Cazurra (2004) building on the theories of the diffusion literature suggest that distinguishing between endogenous and exogenous triggering forces in creating and/or adopting the codes of good governance serves as a useful analytical tool. They argue convincingly that if new governance regulations are born out of the demand of domestic market actors to compensate for the deficiencies in the existing system, the result will be increased efficiency. If, however, best practice codes are introduced as an answer to the

pressure by an exogenous force, it is the legitimization function of the adoption of codes that comes to the forefront.

Taking on this approach we looked at the Hungarian case from the point of view of the triggering force. We made several interviews with the officials at the Budapest Stock Exchange, Ministry of Justice and Law Enforcement and strategic decision makers at Hungarian investment companies. Based on these talks we arrived at the conclusion that it was almost entirely due to exogenous pressures that internationally approved codes of governance were added to the regulatory toolkit of the BSE. The diffusion concept was originated from the European Commission's effort to harmonize the national regulations of corporate governance across the member states.² The chain of the trigger followed the route from the Commission of the EU to the Hungarian Ministry of Justice and Law Enforcement, which delegated the task to the BSE where a national corporate governance committee was set up. Following the EU guidelines and checking their compatibility with the Company Law (as described more in detail in the previous section) the above committee compiled the updated final version Corporate Governance Recommendations of the BSE.

The next step in our analysis of the Hungarian codes was comparing its content with the guidelines which were laid down in the Communication 284 of the EU Commission (COM 284, Table A1 in the Appendix). The documents were not expected to be fully converged since it was open for the Hungarian regulators to contextualize the guidelines so that the Codes were adjusted to country-specific needs. Some authors (Hermes et al. 2007) suggest that domestic forces played a mentionable role in shaping the Hungarian codes of governance. This, however, is not supported by our analysis.

We found that the CGR of the BSE closely follows the guidelines of COM 284 except for three areas (No.4, 9 and 19 in Table A1):

1. The rights, key agreements, direct and indirect relationships between shareholders holding majority stake;
2. Disclosure by institutional investors of the exercise of voting rights in companies in which they invest and the disclosure of voting practices;
3. Collective responsibility of all board members.

In our view the omission of the first point (see above) from the Hungarian codes has not been born out of the concern for country-specific needs, since the missing of this point does not add to the improvement of the Hungarian corporate governance regime. On the contrary, it ignores a crucial corporate governance problem, namely, the one that arises from the high level of ownership concentration of listed companies.

² Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward

Table 3.1 shows the ownership stakes of the three largest blockholders separately and in aggregate. The risk of expropriation of minority shareholders' interest by majority owners increased during the last decade since aggregate holdings of the three largest blockholders has grown from 52,9 (Earle, Kucsera, Telegdy 2005) to 59,8 percent. Assessing the minimum and maximum values in Table 3.1. we can see extreme values, which raise the problem of the biased mean towards outliers. Median values on the other hand imply negative skewness, meaning that the larger portion of listed companies have dominant shareholders.

Table 3.1.

**Ownership concentration on the BSE in the period 2001 Q4 - 2007 Q4
(% holdings)**

Definition	Mean	SD	Minimum	Median	Maximum
First largest blockholder	45,6	21,3	0,0	48,0	99,8
Second largest blockholder	16,0	8,8	0,0	20,1	41,2
Third largest blockholder	7,6	4,0	0,0	6,4	15,0
Largest two blockholders	58,8	21,3	0,0	58,9	99,5
Largest three blockholders	59,8	22,6	0,0	56,9	99,8
All blockholders	64,3	28,4	0,0	62,5	99,8

Note: N (number of firm-years) = 625. N varies by half year with the maximum of 48 in 2002 Q2, 2003 Q4, 2004 Q2, 2005 Q2. SD - Standard deviation. A blockholder is defined as an owner with higher direct ownership than 5 percent

Source: Budapest Stock Exchange; Magyar Tőkepiac; website of listed companies; authors' computations

Figure 3.1 shows that it is non-resident institutional investors that dominate the market followed by the “others” group which comprises governmental agencies and individuals. Local institutional investors command only a 6,2% stake and their investment practices further confirm their status of minority shareholders. This domestic group has a low level of ownership in listed companies because regulations³, with an eye on risk management, limit their holdings in one company to a great extent. Their portfolio strategies, mostly determined by their foreign headquarters⁴ are also moderately conducive to investments in domestic equities.

In order to empirically confirm that concentrated ownership leads to the exploitation of company resources by majority shareholders, we conducted a survey research among the strategic decision makers of local mutual funds. Out of the 12 interviewees 11 claimed that for

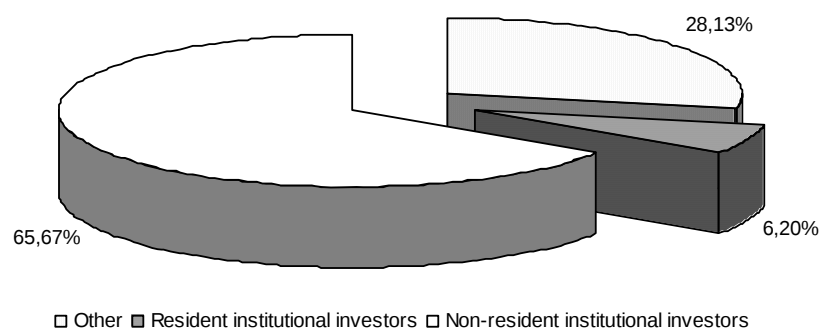
³ Act CXX of 2001 on Capital Market, Act LX of 2003 on Insurance Institutions and the Insurance Business, Act LXXXII of 1997 on Private Pensions and Private Pension Funds, Act XCVI of 1993 on Voluntary Mutual Insurance Funds.

⁴ Except for one single investment company that is owned by domestic shareholders.

them it is the majority owners and strategic owners with majority stake that represent the highest risk of expropriation.

Figure 3.1.

Ownership distribution of resident and non-resident institutional investors on BSE by 2007 Q4.



Source: Budapest Stock Exchange; authors' computations

Concerning the other two missing elements of COM 284 from the CCG of BSE we deem that the disclosure of voting practices of domestic institutional investors is of lesser importance due to their low level of ownership stake in listed companies and their inability to actively participate in corporate decision making. As far as the issue of the collective responsibility of all board members is concerned it is unanimously objected by corporate decision makers.

6. THE QUALITY OF DISCLOSURE

The second issue which we will explore empirically is the quality of disclosure provided by listed companies. We asked ourselves the question: To what degree CGR compliance reports contribute to the correction of information asymmetry? Again, this approach is crucial from the point of view of the interest of the minority shareholders. For blockholders (who dominate the companies of BSE as seen in Table 3.3) the lack of transparency seldom causes a problem since they have an easy access to internal reporting systems not available for smaller owners, for whom CGR reports remain the primary source of information.

While investigating the question of the validity and usefulness of information provided by CGR reports for minority shareholders we also wanted to know what attributes of companies can be linked to the quality of information they reveal in their annual corporate governance statements.

Table 3.3.

Descriptive statistics of the listed companies on the BSE , 2007 Q4.

Category	Mean	SD	Minimum	Median	Maximum
Price (in HUF)	5 364	8 613	24	1 304	33 055
Capitalization (in million HUF)	192 255	538 522	89	13 687	2 580 103
D/E	1,11	3,24	0,00	0,15	18,25
Number of employees	2 673	6 223	2	325	33 062
Free Float (in %)	39,01	27,45	0,20	37,73	89,15
1st largest blockholder (in %)	40,09	25,44	10,85	36,25	89,78
2nd largest blockholder (in %)	16,16	9,65	2,68	12,54	37,76
3rd largest blockholder (in %)	9,86	4,88	5,05	8,16	24,62
4th largest blockholder (in %)	7,45	4,30	0,50	6,30	18,16
5th largest blockholder (in %)	6,51	1,08	5,19	6,35	8,65
6th largest blockholder (in %)	5,47	0,25	5,17	5,47	5,78

Source: Website of Budapest Stock Exchange; Reuters database; authors' computations

Note: N (number of firms) = 37. SD - Standard deviation. Price stand for the sport price of the company at the time of the announcement of the CG report. All outstanding shares are considered to be part of free float or are publicly traded unless it is held by a blockholder. A blockholder is defined as an owner with at least 5 percent direct ownership stake.

We hypothesize that the quality of disclosure is in positive relationship with the size of the company, equity financing, liquidity and the presence of minority owners. To capture these four exogenous factors we use capitalization data, debt-to-equity (D/E, hereafter) ratio, free float share and holdings of the largest owner respectively. We have chosen these indicators for the following reasons. First, research (Griffin, Lemmon 2002) has shown that stock market analysts pay more attention to larger as opposed to smaller (measured by capitalization) companies. This implies that smaller companies are more likely to give empty explanations for the deviation from the statement of the code as the threat of being discovered and published is not so severe. Second, using D/E (long term liability to shareholders' equity) as an indicator for showing the effect of equity financing follows an easy logic. The more a company relies on external equity instead of debt financing, the more it considers the cost of equity important. In order to minimize the financial risk for the investors the company provides better and more detailed information about its internal control mechanisms which reduces the cost of financing. Third, the figures of free float as the variable for liquidity are to mimic the speed of the flow of information (Heflin and Shaw, 2000). News about companies with higher free float travels faster in the market which, as in

the case of analysts' coverage, increases the speed of price reaction. Fourth, the stronger the position of the largest blockholders is, the less is the incentive to care about the proper degree of transparency.

6.1. METHODOLOGY

We conducted our analysis on the corporate governance reports of the 37 listed companies in the Budapest Stock Exchange as of the fourth quarter of 2007. Reports were downloaded from the homepage of the BSE.

To depict the quality of disclosure we constructed five categories of “answer (explanation)”, which are illustrated by a sample in Table 3.4. The categories are the following: category 1 – the answer is “Yes”; category 2 – the company claims that during the year that the report covers no such event has taken place; category 3 – the company declares that a higher order law or regulation⁵ is followed; category 4 – the company argues that the issue raised is inadequate for the company due to firm specific reasons. In this latter case it is of great importance that company specific reasons are elaborated and the chosen alternative is presented in detail; category 5 – the explanation is either missing or inadequate.

⁵ E.g.: Capital Market Act, Company Law, Financial Company Act, Regulation of the Budapest Stock Exchange

Table 3.4.

Samples of explanations according to different “answer” categories.

Category	Explanation (answer)
2	R 2.6.3. Board members informed the Supervisory Board/Audit Committee if they received an offer of Board membership or an offer of an executive management position in a company which is not part of the company group. No, Above described situation has not happened so far
3	R 2.7.7/2. The Remuneration Statement includes information about the remuneration of individual members of the Managing Body, the Supervisory Board, and the executive management. No, According to the Dutch law it is not needed to publish the remuneration of individual members of the Managing Body and the Supervisory body. The company follows the Dutch law and Dutch Corporate Governance and published just the total amount of remuneration of all members, which Management Board accepted as satisfactory information also due to the low number of the Management Board Members.
4	R 2.8.6. The company created an independent Internal Audit function which reports to the Audit Committee. No, just the independent external auditor has been appointed and approved by the general meeting, the function of the internal Audit is provided by the Internal Audit team, that is reporting to the Chairman of the Supervisory Board.
5	R 2.8.6/2. The Internal Audit reported at least once to the Audit Committee on the operation of risk management, internal control mechanisms and corporate governance functions. No, there is no independent internal Audit function.

We will analyze the quality of disclosure in two ways. First, we assess the distribution of answers in the five categories for each statement and by assigning the statements in groups depending on the goal they want to achieve we will be able to show which area of corporate governance seems to be the most problematic. Secondly we will run binary regression in order to establish relationship between our independent variables and the quality of disclosure.

To run binary regression we had to transform the five categories into two groups bearing in mind that the aim of the assessment is to distinguish between adequate and inadequate answers (explanations). The first four categories are considered as adequate or satisfactory answers. Category one is straightforward as it implies compliance with the statement. In case of categories 2, 3, 4 the shareholder is able to acquire sufficient information on the reasons of noncompliance and also to learn about substitute solutions. Answers falling into the 5th category are labeled as inadequate. According to this scheme answers in the first four categories were converted into binary variable 1, while unsatisfactory explanations were converted into 0.

The number of answers (explanations) falling into the five categories are displayed in columns 2 – 6 of Table A2. in the Appendix. The answers in the five categories after the conversion are presented in columns 3 – 4 under binary variables. The last two columns of the table show the regression coefficients.

6.2 RESULTS

Based on the Corporate Governance Recommendations of the BSE we distinguished among four areas of control and the statements were grouped accordingly: (1) Shareholders' rights and treatment of shareholders; (2) Responsibilities of the Managing Body and the Supervisory Board; (3) Committees; (4) Transparency and disclosure.

Table 3.5. shows that inadequate answers (explanations) are detectable in all areas. Serious deficiencies are to be found in descending order in the area of “Committees”, followed by the “Responsibilities of the Managing Body and the Supervisory Board”, “Transparency and disclosure” and finally, “Shareholders' rights and treatment of shareholders.” The majority of statements under the heading of “Committees” was answered but in cases of the negative answer the explanations missed to provide information on the alternative actually applied by the company. Answers to questions related to the creation and the role of nomination companies serve as typical examples.

Company specific type of explanations mainly argued that the size of the company does not justify the creation of committees and some other bodies and stated that the

corresponding tasks are carried out through less formal and flexible ways. Answers belonging to the “guidance by higher order” category indicated the choice of regulation covered by the Company Law, Capital Market Act, or other rules of the BSE. In some cases references to foreign laws were also made.

Table 3.5.

Area distribution of answer categories

	Areas			
	1	2	3	4
Inadequate	2,70%	11,67%	35,27%	10,30%
Company specific	3,60%	16,28%	36,08%	11,32%
Higher order	2,10%	2,64%	3,65%	7,77%
No occasion	21,02%	13,64%	7,03%	7,77%
Full compliance	70,57%	55,77%	17,97%	62,84%
Total	100,00%	100,00%	100,00%	100,00%

Note: The four areas are the following: (1) Shareholders' rights and treatment of shareholders; (2) Responsibilities of the Managing Body and the Supervisory Board; (3) Committees; (4) Transparency and disclosure.

The “No occasion” type of answers typically arose when the statement focused on an event which was not likely to occur in every year. Examples include the reporting obligations of board members in case of change in the status of their independence.

The case-by-base examination and interpretation of answers led us to the conclusion that most of the companies listed on the BSE have not recognized the importance of the provision of good quality information. Thus, the soft law in itself does not seem to be a strong enough incentive to lead to a significantly higher degree of transparency.

Next, we return to our hypotheses about the possible connection between company characteristics variables and the quality of disclosure. Table A2.(Annex) presents the numerical results of the binary regression.

We assumed that the size of the companies and the debt-to-equity ratios are in causal relationship with the readiness to reveal adequate information. The results of our calculation, however, were statistically so weak that we had to reject this causality.

For the two other variables - the share free float and the weight of minority shareholders- the summarized calculations of the binary regression are displayed in Table 3.6. Based on these results our assumptions for these cases can be neither accepted nor rejected.

Table 3.6.

The direction of the relationships between exogenous variables and the quality of information in the four areas of the code.

Areas	Exogenous variables			
	Largest		Free Float	
	+	-	+	-
1	1	0	0	0
2	4	8	10/5*	6
3	3	8/3*	7	2/1
4	2	3	6/4*	1

Note: The four areas are the following: (1) Shareholders' rights and treatment of shareholders; (2) Responsibilities of the Managing Body and the Supervisory Board; (3) Committees; (4) Transparency and disclosure.

Although the results of the regression are unconvincing, we still believe that the outcomes lean more towards our original hypotheses. In Table 3.6. we presented the number of statements where the relationship with the variables is interpretably positive or negative. In the first area (“Shareholders' rights and treatment of shareholders”) there was only one statement with which companies complied as the size of the ownership stake of the largest owner increased. In the other three areas regression coefficients implying negative relationship outweigh the positive ones. This, in line with our hypotheses means that the increase in the size of the ownership block generates more inadequate answers (explanations). In another words, minority shareholders of a company with strongly dominant shareholders are less likely to receive quality information from the assessment of the company’s report of corporate governance practices. This argumentation is further supported in the area of “Committees”, where three out of the eight coefficients are statistically significant at the 5 and 10 percent level.

Regression coefficients displaying the relationship between the quality of disclosure and the extent of free float are mixed as well. Contemporaneously positive figures outweigh the negative ones supporting thus our original premise, i.e. higher liquidity increases the provision of valid answers. In another words, the faster flow of information via more efficient price adjustments pressure companies to decrease information asymmetry. Due to a possible inverse relationship between liquidity and the dominance of blockholders we tested for multicollinearity and were able to reject it.

To sum up: two of our four hypotheses can be partially accepted. The outcome of the computation indicate that the extent of dominance of the largest shareholders and the liquidity of shares induce a degree of systematic deviation from the validity of “comply or explain” declarations.

7. SUMMARY AND CONCLUSION

The appearance of a best practice code of corporate governance is a recent phenomenon in Hungary. It is only from this year that companies are obliged by law to publish their adherence to the codes or justification for non-compliance in their annual reports. Given this short history of experience we had to be cautious with the interpretation of our research results.

The purpose of this paper was to describe the emergence of CGR in Hungary and to examine how this innovative regulation of the Budapest Stock Exchange works in practice. We also tried to back our verbal arguments by the empirical analysis of some aspects of the codes in action.

The introduction of the codes was the direct consequence of the EU Commission's initiative to harmonize national corporate governance regulations across the member states. Thus, the trigger for the implementation of CGR in Hungary came from an exogenous source with little participation of domestic market actors. We subscribe to the view of those researchers who claim that the source of the trigger has strong implications for the efficiency of CGR. Top-down codes that are met by the indifference and passivity of investors and other market participants as it is the case in Hungary at present, makes the diffusion of the true spirit of good governance difficult. Also, while the appearance on paper of Hungarian laws and codes that govern corporate behaviour and disclosure matches European standards, the enforcement of regulations leaves much to be desired.

Based on the assessment of the corporate governance reports of listed companies we inferred that the quality of disclosure is not sufficient enough to eliminate the problem of information asymmetry it was designed to do. In all four areas of the code we found companies which either missed to explain the underlying reason of divergence from the code or provided inadequate explanation. We attribute this behaviour to the weak motivation of companies to court investors by increased transparency, which in turn, is explained by their low dependence on external equity financing. On the BSE the pressure from minority shareholders is fully missing as their power in "devaluating" the company and making it an acquisition target is negligible. Market for corporate control, the main instrument in disciplining the management, is not in practice on the Hungarian market. This fact originates also from the high level of ownership concentration and as a consequence, the lower level of liquidity of shares in line with the slow pace of the flow of information. This causal relationship was partially supported by the results of our regression analysis, where we found that concentration decreases, while higher liquidity increases the quality of disclosure.

Evidence drawn from literature shows that in countries where the codes of good governance have been around for a longer time, are well-established in the system and are

sufficiently monitored, there is a direct positive link between financial penalties and rewards, even companies' performance on the one hand, and the compliance with the codes on the other. While this could be a distant goal for Hungary, at present it is the limitations of the codes that prevail. On the short run, the main merit of the Recommendations of the Budapest Stock Exchange remains their educational and awareness raising function.

APPENDIX

Table A1.

Guidelines of the Communication 284 of the European Commission (COM-284)

Enhancing corporate governance disclosure	
1	The operation of the shareholder meeting and its key powers
2	The description of shareholder rights and how they can be exercised
3	The composition and operation of the board and its committees
4	The shareholders holding major holdings, and their voting and control rights as well as key agreements
5	The other direct and indirect relationships between these major shareholders and the company
6	Any material transactions with other related parties
7	The existence and nature of a risk management system
8	A reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations
For institutional investors:	
9	To disclose their investment policy and their policy with respect to the exercise of voting rights in companies in which they invest
10	To disclose to their beneficial holders at their request how these rights have been used in a particular case
Strengthening shareholders' rights	
11	Shareholders of listed companies should be provided with electronic facilities to access the relevant information in advance of General Meetings
12	Provisions for cross-border voting
13	Shareholder democracy: The one share – one vote principle
Modernizing the board of directors	
14	In areas where it is possible for conflicts of interest to rise (remuneration and supervision of the audit, reappointment of directors), decisions should be made by non-executive directors
15	Disclosure of remuneration policy in the annual accounts
16	Disclosure of details of remuneration of individual directors in the annual accounts
17	Prior approval by the shareholder meeting of share and share option schemes in which directors participate
18	Proper recognition in the annual accounts of the costs of such schemes for the company
19	Collective responsibility of all board members

Table A2.

Number of answers (companies) in the answer (explanation) categories and the results of the binary regression.

Statements CCG	of	Answer categories					Binary variables		Regression coefficient	
		1	2	3	4	5	1	0	Largest	FF
1.2.9/2.		23	0	1	6	7	30	7	3,071 (2,144)	-1,418 (1,550)
1.3.8/1.		15	20	1	0	1	36	1	-2,108 (3,957)	-0,993 (3,674)
1.3.8/2.		11	24	1	0	1	36	1	-2,108 (3,957)	-0,993 (3,674)
2.3.1/1.		35	0	0	1	1	36	1	27,536 (37,152)	-5,157 (5,214)
2.3.1/3.		29	1	0	4	3	34	3	1,963 (2,821)	-0,218 (2,209)
2.3.1/4.		24	5	0	4	4	33	4	3,950 (3,151)	-3,223 (2,156)
2.5.1.		28	1	2	5	1	36	1	-17,301 (17,092)	5,323 (6,721)
2.5.4.		14	2	4	13	4	33	4	-0,335 (2,082)	-0,705 (1,928)
2.5.5.		14	5	3	11	4	33	4	1,635 (2,379)	-1,618 (1,953)
2.5.7.		8	0	9	7	13	24	13	1,464 (1,453)	0,430 (1,283)
2.6.4/1.		29	0	2	4	2	35	2	-1,557 (2,809)	-0,362 (2,655)
2.6.4/2.		27	1	4	3	2	35	2	-1,557 (2,809)	-0,362 (2,655)
2.7.1/1.		15	0	0	12	10	27	10	-1,020 (1,460)	0,605 (1,394)
2.7.1/2.		13	1	0	9	14	23	14	-1,056 (1,353)	0,314 (1,259)
2.7.1/3.		17	3	1	7	9	28	9	-1,291 (1,510)	1,989 (1,586)
2.7.2/1.		29	1	0	3	4	33	4	4,881 (3,589)	-3,025 (2,121)
2.7.2/2.		27	4	0	2	4	33	4	4,881 (3,589)	-3,025 (2,121)
2.7.3/1.		25	0	0	10	2	35	2	-0,377 (2,849)	0,946 (2,839)
2.7.4/2.		14	21	0	0	2	35	2	2,304 (3,573)	-3,581 (3,069)
2.7.7/1.		13	2	1	12	9	28	9	-1,880 (1,531)	3,293* (1,811)
2.7.7/2.		8	3	1	13	12	25	12	-2,052 (1,432)	3,433** (1,643)
2.8.1/1.		33	0	0	2	2	35	2	1,623 (3,304)	-0,375 (2,654)

2.8.1/2.	35	0	0	1	1	36	1	27,536 (37,152)	-5,157 (5,214)
2.8.1/3.	35	0	0	1	1	36	1	27,536 (37,152)	-5,157 (5,214)
2.8.3/1.	29	0	0	4	4	33	4	-0,385 (2,079)	2,470 (2,372)
2.8.3/2.	32	0	0	3	2	35	2	-2,081 (1,844)	10,325 (8,181)
2.8.4.	29	0	0	6	2	35	2	4,504 (4,841)	-0,476 (2,649)
2.8.6/1.	12	0	1	19	5	32	5	-1,750 (1,884)	1,340 (1,919)
2.8.6/2.	12	0	1	13	11	26	11	-1,422 (1,431)	2,663* (1,565)
2.8.7/1.	7	0	1	19	10	27	10	-2,184 (1,503)	5,427** (2,237)
2.8.7/2	15	0	0	10	12	25	12	-1,908 (1,424)	3,921** (1,735)
2.8.8.	12	0	2	13	10	27	10	0,116 (1,480)	1,017 (1,422)
2.8.9/1.	15	0	2	10	10	27	10	-0,285 (1,466)	1,895 (1,507)
2.8.9/2.	18	0	1	8	10	27	10	-1,046 (1,460)	1,872 (1,509)
2.8.11.	22	4	0	6	5	32	5	-0,527 (1,883)	2,034 (2,044)
2.9.3/1.	14	21	0	1	1	36	1	7,461 (10,584)	-1,674 (3,725)
2.9.3/2.	12	7	5	9	4	33	4	1,723 (2,400)	-3,062 (2,127)
3.1.6.	13	0	5	10	9	28	9	-0,801 (1,507)	1,631 (1,540)
3.2.1.	18	0	7	4	8	29	8	-1,267 (1,568)	3,667* (1,989)
3.2.3.	22	1	1	8	5	32	5	-0,910 (1,872)	2,070 (2,051)
3.2.4.	16	15	2	1	3	34	3	-0,694 (2,342)	-0,808 (2,190)
3.3.1.	1	0	3	28	5	32	5	3,244 (2,571)	-3,575* (2,023)
3.3.2/1.	3	1	1	17	15	22	15	-1,199 (1,345)	0,457 (1,246)
3.3.2/2.	2	1	1	15	18	19	18	-1,376 (1,344)	1,057 (1,240)
3.3.2/3.	2	0	1	14	20	17	20	-1,586 (1,347)	0,933 (1,233)
3.3.2/4.	3	1	1	14	18	19	18	-1,376 (1,344)	1,057 (1,240)
3.4.1.	5	0	1	25	6	31	6	2,583 (2,179)	-2,436 (1,719)
3.4.2.	6	0	0	16	15	22	15	-0,610 (1,333)	0,402 (1,245)
3.4.3/1.	5	0	0	18	14	23	14	0,056 (1,352)	0,151 (1,255)

3.4.3/2.	5	2	0	17	13	24	13	-1,312 (1,377)	0,541 (1,288)
3.4.3/3.	4	7	0	13	13	24	13	-0,820 (1,367)	0,897 (1,305)
3.4.4/1.	6	0	0	12	19	18	19	-2,645* (1,450)	2,139* (1,307)
3.4.4/2.	4	0	0	15	18	19	18	-3,210** (1,499)	2,593* (1,358)
3.4.4/3.	3	0	1	16	17	20	17	-3,227** (1,492)	2,437* (1,354)
3.4.7.	4	4	1	14	14	23	14	-1,305 (1,360)	2,087 (1,377)
3.5.1.	1	19	1	4	12	25	12	1,640 (1,506)	-1,456 (1,316)
3.5.2.	10	1	1	6	19	18	19	-0,140 (1,311)	-0,123 (1,215)
4.1.1.	23	0	9	2	3	34	3	-2,753 (2,439)	0,527 (2,282)
4.1.3/1.	23	0	9	2	3	34	3	-0,042 (2,395)	1,079 (2,370)
4.1.4.	27	0	3	4	3	34	3	0,454 (2,463)	-1,781 (2,230)
4.1.5.	18	0	3	9	7	30	7	-2,165 (1,679)	0,785 (1,603)
4.1.6.	30	0	4	1	2	35	2	-0,255 (2,862)	13,715 (10,554)
4.1.8.	19	15	1	0	2	35	2	52,382 (49,321)	-5,254 (3,753)
4.1.9.	25	1	1	6	4	33	4	2,923 (2,752)	0,084 (1,962)
4.1.10.	16	0	1	10	10	27	10	-0,325 (1,465)	-0,374 (1,261)
4.1.11.	12	3	1	13	8	29	8	-1,773 (1,583)	2,543* (1,960)
4.1.12.	14	0	2	12	9	28	9	-0,979 (1,507)	1,672 (1,545)
4.1.14/1.	15	1	10	3	8	29	8	-2,549 (1,633)	1,869 (1,644)
4.1.14/2.	24	8	1	3	1	36	1	-1,533 (3,904)	6,456 (7,744)
4.1.15.	17	18	0	1	1	36	1	4,727 (7,105)	6,073 (7,390)

Note: Statements of CCG – recommendations of the code of corporate governance issued by the Budapest Stock Exchange. Standard error shown in parentheses, *** - statistically significant at 1% level, ** - statistically significant at 5% level, * - statistically significant at 10% level. Largest - Ownership stake of the largest shareholder; FF - Free float; Binary variables: 0 - no, 1 - yes answer to the declarations of the code.

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