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THE CAUSES OF INFLATION IN HUNGARY AND THE PROSPECTS FOR ITS REDUCTION

I. HAGELMAYER

In searching for the causes of the current level of inflation, it is not unreasonable to assume that it is precisely the economic policy of earlier years (1973–1978) and the justified correction of this economic policy, that have led to the undesirable side-effect of inflation. Thus, if this proves to be true, or even partially true, the question may arise as to whether the suppression of inflation at all costs would not slow down or stop the correction process. In his analysis of the causes of inflation, the author puts his finger on the general aspects he considers the most significant: this makes it clear that the questions involved affect Hungarian economic policy, the economic management system and the mechanism as a whole.

Early socialist economic literature understood the gradual sinking of the price level as a law of economics (which was never supported by reality). The argument said that the continuous improvement of the productivity of labour diminishes the value of products, and price adjusts itself to the value. Therefore, if the diminishing value of products is a general tendency—which may be of a different degree in the case of different products—, *also the general* price level must be continuously getting lower.

The theory aiming to explain reality (that was different from the abstract theory) did not try, in the beginning, to provide a complex analysis of the factors affecting the general price level. It expected to find a satisfactory explanation of the unforeseen changes in the price level in a cost-push by certain products or groups of products, which diverged from the general tendency—and the spill-over effects of this process (due to rising marginal costs of the extractive industry and agriculture, deteriorating natural conditions, increasing costs of environmental protection, etc.). Beyond doubt, all these are important elements of the changes in *relative prices,* but they do not give sufficient reasons for a rising *price level,* as relative prices may also change if the price level is *unchanged* or decreasing. I think we shall find the proper formulation if we consider inflation as an economic phenomenon, the causes of which can only be grasped when considering the entire *process of reproduction,* i.e. it depends on production, distribution, and consumption of goods and services and on the factors determining the proportions of the latter. As the socialist state's economic policy, economic organization activity and regulation play an active part in the general economic process, the interpretation of the state's role is not to be disregarded in the analysis of the causes of inflation. In the analysis that follows we shall try to point out the most important general aspects.

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Ratio of domestic production and consumption

Following the 1973 world market price explosion, Hungary's terms of trade seriously deteriorated. In order to maintain the balance of foregin trade, the *volume* of exports ought to have been increased to the extent to which the *price level of imports* rose above the increase in export prices. This would have reduced domestic commodity supply which, the demand position of money holders remaining unchanged, would have pushed the price level upwards. That is, the pressure of inflation would have manifested itself at that time. However, this is not what in fact happened. The economic leadership considered it important to keep up the accustomed growth rate and to further raise living standards and increase investments. In those years, all this was made possible by international credits, available in abundance, which Hungary used to an increasing extent.

Imports regularly exceeded the growth of exports (with the exception of 1975) and it is worth mentioning especially that, while the growth of import prices was usually above that of export prices, the *volume of imports* was growing faster than the volume of exports, with the only exception of the above-mentioned year. Thus it happened that by 1978 the import surplus had already reached 9.2 percent of the GDP.

Producers were not compelled to adjust themselves to the changed conditions of the world economy and improve their competitive position. Therefore, there was no guarantee that the increased investments would improve efficiency of production and, in this way, of the whole economy. Further, it became clear that increased production—if its structure remains the same—only adds to the debt stock. Imports regularly exceeding exports *enabled* the raising of the living standards beside increased investments, as domestic consumption exceeded domestic production.

Taking these points together, the generalized statement may be made that if an economy, in a situation of deteriorating terms of trade, is unable or is not compelled to react to an accelerated rise of the import price level by increasing its volume of exports—thus decreasing domestic commodity supply—, it may, *temporarily,* get rid of the heavy burden of inflation. However, it *has* thus *not solved* the problem but only *postponed* it. The solving of the problem is left to the future. This future is, however, our present.

The change started in 1979. In comparison with the previous year, the volume of exports grew considerably (by 15.6 percent), while the volume of imports—compared with the exceptionally high level of the preceding year—fell to a large extent (-9.6 percent). The import surplus fell by more than half in comparison with 1978 and its ratio relative to the GDP from 9.2 to 3.3 percent. Following two "quiet years" (1980, 1981), the growth of exports went once again above 10 percent in 1982 and 1983, whereas imports were decreasing (1982), or hardly rising (1983). Thus 1982 was the first year, since 1973, in which *domestic consumption (productive and personal* *consumption combined) stayed below domestic production*—which is to say that after more than a decade, Hungary had an export surplus (0.8 percent of the GDP). An export surplus reduces domestic commodity supply, and therefore—*ceteris paribus*—it is a factor pushing the price level upwards.

However, can one say that it was *first* in 1982—i.e. when the balance of Hungarian foreign trade had a surplus—that inflationary pressure elicited by reduced domestic supply presented itself? No, this factor had been present in the Hungarian economy ever since 1979, as the change in the domestic distribution of a given year is not determined by the deficit or surplus of the foreign trade balance, but by *the change in comparison with the previous year*. Also, from 1979 on, import surplus *had decreased each year* (in the GDP 3.3 percent in 1979, 2.2 percent in 1980, 1.1 percent in 1981) and from 1982 the foreign trade surplus had been rising (up to 1985).

The domestic commodity supply is reduced by growing exports, as well as by decreasing imports. Therefore in these years (1979 onwards), inflationary pressure ("deferred to the future" in 1973–1978) has been present with a greater weight, and it is possible to diminish it only if strong countervailing factors are functioning or can be brought to function in the economy.

As for the relationship between inflationary and foreign economic processes, therefore, two phenomena have been called to attention: the domestic price level is affected by the foreign trade balance, and by changes in the terms of trade (among other things). Yet, although the increasing debt service of the country demands a *surplus* in the balance of trade, it is only in the ideal case of a *significant improvement in the terms of trade* that this will not lead to the rise of the domestic price level. However, Hungary could reach a surplus in its trade balance only with the *terms of trade continuously deteriorating*, which weighs on the domestic price level to an even greater extent than the nominal size of the surplus. The rising domestic price level is, of course, a problem in itself, even if only a consequence. Yet a much greater problem is that a growth of the export volume coupled with deteriorating terms of trade results in a self-exhausting process. Under such circumstances, *the gap between input and yield is gradually narrowing in general, the ratio of products manufactured with a loss is growing* (and it is not possible to live on loss). If all this is accompanied by a poor quality of an increasing number of products, the market for them is also likely to diminish. This problem cannot be solved by increased export subsidy; satisfactory improvement can only be expected if there is a radical transformation of the production structure providing a basis for profitable exports. (Under the fundamentally changed world economic conditions, the development of the branches of industry now supplying the bulk of Hungarian exports against hard currencies does not even promise a gradual reduction of losses). Also, a structure that has been formed over a number of decades cannot be transformed from one day to the next (however, transformation could, and ought to be accelerated). Therefore, we cannot expect, in the immediate future, to get rid of the inflationary pressure engendered by foreign economic relations. We can hope for its reduction, *but this hope can only be based on the accelerated transformation of the production pattern.*

Inflation and the money income of households

In the preceeding section I have tried to give an idea of the effect the export-import balance can exert—through reduction or growth of commodity supply—on the price level of a given country. The statement has been made that import surplus—in itself—is concomitant with a sinking price level, whereas export surplus entails a rising price level. However, prices were rising in Hungary when the country had a credit-financed import surplus, as well as when an export surplus was achieved.

Therefore, the relative changes of households' money incomes and consumer prices will be examined. The analysis could be reliable only if changes in *household money incomes* were compared with those in the domestic supply of *consumer goods* (even then only to a limited extent, as households do not only buy consumer goods and not only households buy consumer goods). However, in investigating the changes in the supply of consumer goods, serious statistical difficulties are encountered. Thus for simplicity's sake, the growth of the GDP at unchanged prices was made the basis of comparison. This can give a reliable result only if *it is assumed* that the ratio of accumulation to consumption, and further, the foreign trade balance of consumer goods remain unchanged (this is too much to assume, but we shall later on try to correct this first error).

It is a trivial but true correlation that, if household demand supported by money income exceeds supply, a market balance can only be reached at a higher price level. If, first, the growth of wages and of wage-like incomes is considered the factor determining demand, whereas the growth of the GDP represents the change in supply, an *unchanged price level* can be expected, if *the two growth rates are* identical. Yet already in the years between 1974–1978, when the growth rate of the GDP was high above its present one, the increase of wages exceeded the growth of the GDP *each year* (see *Table 1*).

These ratios themselves provide an explanation for the rise in the consumer price level, as well as the disequilibrium on the domestic market, as wage incomes are rising faster than supply. *Demand is,* however, *further increased* by social benefits in money (the growth of these between 1974–1978 in the order of years: 16.9, 17.7, 14.4, 10.5, 9.5 percent); while *supply*—in any way behind demand—is *further reduced* by social benefits in kind (the growth of those in 1974–1978 in the order of years: 6.6, 11.5, 8.1, 10.5, 15.1 percent). This is the reason why—with a relatively high economic growth and an import surplus—the consumer price level was rising (at an average of 3.8

Table 1

The yearly growth rate of the GDP and of wages in Hungary

Year	Growth rate of GDP at constant prices	Growth rate of wages and wage-like incomes
1974	5.9	8.7
1975	6.2	7.9
1976	3.6	4.2
1977	7.6	9.5
1978	4.4	8.2

percent over a 5 year period). Although the subject would be worth an analysis itself, the fact has to be pointed out that the growth of wages surpassed the growth of labour productivity each year.

From 1979 on, the situation changed substantially. *Each one of the inflation-generating factors grew stronger*. The utilization of external resources decreased, and so did the economic growth rate, as well as the growth rate of labour productivity. However, the outflow of wages (i.e. its growth rate), and the growth of social benefits remained practically the same. No wonder that the rate of consumer prices accelerated. It is worth having an overview of all these factors (see *Table 2*).

Table 2

Changes in the factors affecting inflation in Hungary

(percent)

	Growth of				
	GDP	wages	total social benefits	produc-tivity	consumer price
1979	2.7	6.7	13.3	2.5	8.8
1980	0.2	6.8	14.3	1.3	9.6
1981	2.9	8.2	11.0	4.1	4.6
1981	2.8	6.8	10.0	3.1	6.9
1983	0.8	8.3	8.0	1.6	7.3
Average growth	1.9	7.4	11.0	2.5	7.4

Although the 1979 turn of the Hungarian economic policy was necessary, being late, it could not set itself high-flying targets. Consequently, because of accumulated tensions, it could only aspire to correction of earlier errors. That is why the restoration of the external equilibrium, and the maintaining of living standards became tasks of first priority. However, with the given product pattern—and when, with the general growth, export capacities were far behind the import demand of production—this was *only possible if the growth rate was slowed down.*

Thus, the slowing down of the growth rate can be considered as one of the *means*—resorted to *by necessity and only temporarily*—of the correctly set targets. At the same time, it is clear that slow growth will lead to an economic recovery only if the transformation of the production and product structure, the measure of which is the value judgement of the world market, *accelerates.* This process has remained far behind expectations. (That is to say, the "slowing down" of growth rate was put into practice, but the "acceleration" of structural change was not.)

The increase of wage-levels is no accident, either. In spite of the slowing down of the economic growth rate, the government deliberately allowed wage outflow to exceed the growth of supply (which was not qualified by the fact that wages were usually rising somewhat faster than planned), relying on the fact (supported by domestic as well as by international experience) that *the downward change in wages is rigid.* Therefore, *differentiation* of wage rates, which is by all means necessary, is only feasible if the wage level is *rising.*

Thus a wage outflow exceeding the growth of the GDP can be accepted—together with inflation—as a rational means of stimulating more efficient work, *only* if a differentiation of wage rates is taking place at the same time. However, few signs show such changes.

The established system of *social benefits* represents a virtually unchanging factor for every government. This can be explained by easily understandable socio-psychological reasons. For the affected, the grants received through the years independent of work are seen as inviolable rights, and it is the awareness of being entitled to them that most sharply opposes the arguments referring to rationality, or more exactly, to the changed economic situation. It is true, though, that under inflationary conditions, *it is the erosion of the real value of grants (benefits) which is the fastest*—whereas the growth rate of *total* grants (benefits) may exceed any *growth rate* representing supply and demand. In Hungary, this has been happening for the last fifteen years. It is especially since 1979 that the "gap" has opened wide. Thus the growth rate of social grants, (benefits) by far surpassing that of domestic demand, is *one of the causes* of inflation. On the other hand, a *notable* decrease in the growth rate of grants is excluded—in addition to unchanged schemes and automatism—by the fact that the decrease in real values enforces repeated corrections. This is, in the majority of cases, little for those affected, while it is an increasingly heavy burden on society.

The early socialist literature was wrong in drawing the conclusion that, by increasing productivity, the price level would be gradually lowered, because it neglected other factors. Yet it is just as great an error to ignore the effect of labour productivity on the price level. Approaching the question from the grounds of the theory of value, it is clear that *improving labour productivity*—if it is considered to be general and affects every product—*decreases the value of goods,* i.e. presses the price level downwards. Therefore, in the examination of correlations between wages, labour productivity and prices, the statement can be accepted, in the first approximation, that the price level can remain unchanged in the case of the growth rate of wages and that of labour productivity, remaining identical. It follows that *a wage outflow higher than the increase of labour productivity will push the price level upwards.* In Hungary, this divergence is almost permanent.

Inflation and the ratio between accumulation and consumption

The changes in the ratio between accumulation and consumption (called rate of accumulation in the Marxist theory) also affect the level of consumer prices. If the rate of accumulation grows, while that of consumption decreases, *ceteris paribus* this will push the consumer price level upwards.

In the years from 1973 to 1978 the *rate of accumulation was generally rising,* along with the use of considerable and increasing amounts of external resources. The process turned in 1979: from then on, *the rate of accumulation has been decreasing from year to year.* Thus, between 1973 and 1978 the changes in the rates in question exerted an *inflationary effect* on the consumer market (which was, of course, largely mitigated through the growth of demand enabled by the use of external resources); from 1979 the changes in the rates exerted an *anti-inflationary effect,* which, however, could not counterbalance the much stronger pressure of other inflationary factors.

The change in the ratio of accumulation and consumption was the intended outcome of the modified economic policy. The improvement of the external equilibrium could not be further postponed, and, undoubtedly, after years of providing for the continuous rise of living standards, it was not going to be easy for the leaders of the country to have the stagnating living standards accepted by the people. These two targets demanded a change in the ratio of accumulation and consumption. It is, however, to be noticed that such a combination of targets and means can be maintained only if, with a view to achieving the targets, a radical change is made in production: not just any change, but one that is accepted by the world market's value judgement. Relying on experience, we can definitely make the statement that it is exclusively after or within the accelerated process of such structural transformation that it becomes possible to slow down the deterioration of the living standards, and later, following the economic recovery, to raise them. If this condition is not fulfilled, the targets set cannot be achieved, and inflation remains with us—an unwanted companion.

The reserves of the anti-inflationary effect that can be achieved through such change of the rates have been exhausted. They have been exhausted if it can be demonstrated that—and several signs point to this direction—the existing rate of accumulation already hinders technical progress (which can be, *in the long term,* a very hard inflationary factor).

The state budget and inflation

In the previous analyses the task was relatively easy, as it was attempted to demonstrate correlations that had already been revealed and accepted in the literature dealing with inflation. However, the socialist economic literature has not so far examined the role of the budget in inflation in full detail.

The economic disputes of the 1970s were concerned, quite naturally at the time, with the economic nature of the *budget deficit* and its causes and economic effects. They suggested—independent of the authors' intentions—that a balanced budget has a neutral effect on the price level.

Let us, however, focus our attention on the budget *deficit.* Even though it is not possible here to set forth the positions taken in the dispute in all detail, it can be stated that there were no essential differences in views concerning judgement of its effect on inflation. This consisted of the belief that the budget deficit pushes the price level upwards if the deficit is bigger than the money savings of other money holders (households, enterprises). This was no rare phenomenon in the 1970s. On the other hand, it is clear that if domestic (productive and personal) consumption regularly exceeds domestic production, *additional quantities of money* are needed for selling the products—thus money is created by credit, which simultaneously entails *debt.* That is to say, one of the money holders is bound to run into debt. The budget contracted as much debt with the National Bank as the extent to which its expenses surpassed its share in the money incomes from domestic production—in other words, *as corresponded to its role undertaken in realizing the supply surplus.* This was clearly the result of the prevailing *economic policy* which *determined* the budget position through its decisions (incurring of debts, living standards policy, investment policy, policy of subsidies, etc.).

Also in those years, the major cost items of the budget showed *rather high fluctuations.* To illustrate this, a few data are presented below (see *Table 3*).

Directly or indirectly, through its expenses the budget enables realization of products and the use of services, and it can contribute to the modification of income positions (with subsidies). Therefore, it is to be assumed that the sudden changes in certain expense items affect the demand and supply conditions of the partial market concerned, as well as the changes in their prices—even if the consequence of this cannot be demonstrated for each item. The changes in the current subsidies to enterprises and cooperatives, and in the consumer price subsidies, show that in the period in question

Table 3

Growth rate of the major expense items of the Hungarian budget

(preceding year = 100)

	Accumulation expenditures	Current subsidies to enterprises and cooperatives	Consumer price subsidies	Budgetary organs	Social insurrance (security)	Total expense
1974	117	166	110	111	118	122
1975	124	101	111	111	118	111
1976	100	86	126	103	115	102
1977	107	131	109	108	101	113
1978	92	100	108	114	108	106

priority was given to *enterprise stability* and the *protection of the consumer price level.* It is to be pointed out once again that the same thing led to *conservation of the production pattern* and *separation* of the consumer prices from the production costs. This did not solve but, instead, accumulated problems—thus adding to the difficulties of the current anti-inflationary policy.

Improvement of the external equilibrium required the *reduction* of domestic (productive and personal) consumption, especially as it was accompanied, out of necessity, by slow growth. Also, due to the lack of enterprise propensity for saving, this had the inevitable consequence of an increased centralization of enterprise incomes. No other alternative arose at all, and its expediency was never doubted in the earlier years. The menacing insolvency of the country even intensified such assertions. This is what had led to the gradual freezing of the enterprises' obligatory reserve funds (later to their taxing away), to the imposition of various duties and taxes and, in general, to making production factors more expensive by means of taxes. Painful as this process may have been for the enterprise sector and however much trouble it may have caused in enterprise management, it would be useless to deny that, under the given circumstances, *it was exactly that fiscal policy that corresponded to the system of economic policy priorities.*

This statement having been made, it will be worth summing up the critical views which, in a system of changeable priorities, retrospectively judge the *fiscal policy as generally negative.*

Taxation

It is a recurring criticism that the increase in taxes contributed, through their *shifting,* to raising the producer price level. In other words, the taxation policy of the period was basically *inflation-generating*. Producer prices were *in fact* rising (from 1976 to 1979) *more slowly* than consumer prices every year, but in 1980–1981 they were rising faster than consumer prices; however, in 1982–1983 the rise of the producer price level again remained below the growth rate of the consumer prices). The effort to shift taxes is a natural reaction of every economic unit, but the result depends on economic power conditions. The shifting over cannot be successful, if the price prior to imposition of the tax was an equilibrium price, if the buyer can choose between potential suppliers, and if the buyer is not in a position to shift the tax onto others (when it is in his *fundamental* interest to maintain its economic position: profitability, liquidity, solvency, etc.). The existence of these conditions is, however, not typical of Hungary, and therefore the shifting over of some of the taxes cannot in fact be excluded. Thus the *objective* of the imposition of taxes, to give an impetus to make greater efforts, fails to be realized. Yet this in itself does not render the rationality of the objective doubtful (this is particularly valid if no other instrument is available). Instead, it is a warning that the *conditions* for the desired effect must be created. All this makes it necessary to break the enterprises' *monopolistic positions* and to increase, by every possible means, *their cost-sensitivity*—including the veritable risk of *bankruptcy*.

System of taxes

The existing tax system of Hungary is the result of several, simultaneously emerging necessities, in which an optimum combination of resources cannot yet be guaranteed. It is also true that the tax imposed on production is an element of the producer price. Therefore, it is essential to analyze and further develop the system of taxation. Why does, however, this question arise in connection with inflation? The fact that the bulk of the incomes drawn into the budget constitutes a part of the producer price has no importance from the point of view of inflation (in a static approach). It will only be justified to ask this question if it is proved that *the possibilities of the shifting on of taxes* imposed on costs, and of those imposed on profit, *are different*. However, no analyses of conclusive force are known on the subject. Logically it can be assumed that it is easiest to shift on taxes (duties) accounted along with costs, while the most difficult thing is to shift taxes to be paid from the firms' funds. Yet even this is true only if there is no obstacle in the way of shifting on all costs. For illustration, let us mention, that *the raising of the wage tax was motivated* by a dual intention: first, to stimulate a *more rational labour economy;* second, to make those *costs of the reproduction of labour* which are manifest on the *social* level (or at least their majority also appear among the *enterprise cost items*. There were disputes as to the extent of the exercise, whereas the rationality of the objective was never doubted. On the other hand, if it can be assumed that this, too, contributed to raising the producer price level, the (partial) failure of the economic policy objective may be stated. However, the cause is to be looked for in the circumstance in which the economic system as a whole does not prevent the shifting on of costs (and of taxes).

Subsidies

The correlation between *subsidies and inflation* is to be defined in different ways *in the short and in the long term.* The subsidy the producer receives enables him to produce at such a high cost level that consumers or buyers can hardly bear the eventual price without a subsidy (the granting of the subsidies may be explained by either production policy, or consumption policy considerations). Thus a subsidy enables the maintenance of low prices breaking away from costs, and is, as such, an *anti-inflationary* factor. Yet the producer is not compelled to improve the efficiency of its activities, or in the worst case, to stop them—which thus makes the production pattern rigid; further, the consumer or buyer does not sense the actual social costs, and therefore the "lack of reaction" (search for substituting products and other sources of purchase, transformation of the consumption pattern, etc.) make the social loss permanent. Finally, the condition of a subsidy is taxation, which holds back, as is well known, development of the otherwise profitable fields. All this represents a serious *inflationary factor* for the future.

After the first sudden rise in oil prices, this form of subsidy became prevalent, what is more, it received a conceptual-ideological content, and led to the accumulation of subsidies (particularly in 1973-4). Later, in the second half of the 1970s, the concept underwent a gradual change, until finally the reduction of subsidies became a catchword. However, putting this reduction into practice was not a complete success. This is partly explained by the fact that the earlier accumulated subsidies had been built into the system of economic relations, constituting a part of the established and accepted system of consumption and living standards. Thus any move from there—even a positive, or rational move—disturbs *spheres of interests* and entails temporary economic and social *conflicts.* In Hungary, "interests hurt" may easily appear in the guise of "social interests" because of the lack of open forums for conflicting interests. On the other hand, the slowness of the process of reducing the many kinds of subsidies is accounted for by the *uncertainty of the economic policy.* We do want the transformation of the product pattern, and the abolition of lossmaking activities. However, if this causes shortages such as can only be compensated by imports, or if it threatens us with unemployment (even if only temporarily), these worries—which are not unfounded—lead to postponement of the necessary decisions, and subsidies will thus remain.

The fast increase of wages, and the accelerated external placement of resource demanded, in order to maintain internal equilibrium, the raising of consumer prices, which enabled the reduction of subsidies in consumption. It is true though that this had no feedback effect on production.

One consequence of increased centralization was that, through the higher requirements, it increased the number of enterprises whose efficiency was lagging behind the higher average. Those who were thus lagging behind asked for a *subsidy*, or *tax-relief* and in most cases their demands were satisfied (except for a few extreme cases of enterprises unimportant as regards volume and staff number which were declared bankrupt). *Thus, though certain changes have been made, yet nothing has changed in substance,* as the enterprises making high profits could not develop at a fast rate, and the loss-making enterprises could continue functioning.

Monetary policy and inflation

According to the statutes of the National Bank of Hungary, one of the Bank's duties is to protect the value of the forint. This, however, was not enabled either by its internal *organizational system,* or by the *outer environment* determining its activities (above: the over-determination of the national economic plan, below: cost-insensitive enterprises). The amount of money needed in circulation was determined by factors outside the Bank's sphere of competence (wages, taxes, subsidies, prices, etc.). All that was left to it was a passive follow-up of processes. The renewal of expired credits caused no difficulty in its work (this is, however, an inflationary factor) and the relatively high deposit rate charged to enterprises does not encourage enterprises to have monetary savings. Also, the hardly justifiable high interest rate on credit has not led (beside the aim of drawing away income) to a selection of credit demands based on economic rationality.

The *two-level banking system,* already functioning in 1987, provides the institutional framework for the development of a *monetary policy* on the one hand, and for loans *based on business considerations* on the other. A lot depends on how much of the above-mentioned environmental circumstances will be changing at the same time, as this is necessary for the newly formed institutional system to bring about new economic contents and to play a positive role in controlling inflation.

Rate of exchange policy and inflation

The opinion has spread in connection with the exchange rate policy of recent years that the forint has been devalued, because *devaluation was to encourage exports.* At the same time, however, the devaluing exchange rate policy was one of the *significant* elements in the *inflationary process*. Of course, the export-stimulating aim of a devaluing exchange rate policy cannot be denied and it is not impossible, either, that in a given case devaluation will raise the domestic price level. The analyses of the author have not *proved* any of these statements (the doubts voiced are not meant for provocation: as a rule, decisions for the *future* are made in consideration of *past* experience—therefore, the past that is misunderstood may give a wrong orientation).

If it is in fact the *rate of exchange* and the *changes* in it that exert a perceptible effect on exports, they should be assumed to raise export prices expressed in *forint*, and to increase the receipt-proportional *profitability* of exports, thus leading to increased export *volumes*. No economically interpretable correlations have been found between the three factors. *Table 4* is given below to illustrate the fact.

Table 4

A few factors concerning exports settled in convertible currencies

Year	Non-rouble exports		
	Change in volume (percent) previous year = 100	Income-proportional profitability (percent)	Change in prices measured in forint (percent), previous year = 100
1980	2.2	12.84	103.6
1981	1.7	12.17	103.00
1982	10.7	9.05	98.6
1983	10.8	9.11	105.5
1984	5.0	10.00	105.7

We have, therefore, formed the opinion that in Hungary *it has not been the rate of exchange* and the *changes* in it that have affected export volumes but, in addition to external and internal demand, factors *outside* the rate of exchange (for example, wage preferences, premiums of enterprise managers, etc.). It is perhaps not devaluation, but incomes flowing *outside the rate of exchange* that have caused—of course, only partially—inflation. (These are, however, individual forms of incentive which conserve the export structure more than anything. They are not, by their nature, apt for eliciting any rational flow of capital, not even if established channels existed for it.)

Upon these grounds alone doubts may arise as to the inflationary effect of the forint devaluation. However, it is also worth considering how the mutual proportions of foreign and domestic trade *prices* and the *changes in the rate of exchange* have been developing during recent years (see *Table 5*).

Relying on the above, it is justified to argue that, as the rise in *producer prices* was *much* higher than the *increase in export prices*, the widening gap between the two was only *partially* compensated by devaluation. Thus the change in the rate of exchange in itself had, the devaluation notwithstanding, not an inflationary, but a *deflationary* effect.

Table 5

Correlation between the rate of exchange, foreign and domestic trade prices

Year	Change in the rate of exchange in relation to the basket*	Non-rouble export price	Non-rouble import price	GDP deflator index	Industrial producer price index
1980	92.9	103.6	102.0	105.3	115.3
1981	97.2	103.0	100.8	105.5	106.3
1982	103.1	98.6	99.7	105.4	104.7
1983	112.9	105.5	108.1	105.8	105.6
1984	108.5	105.7	108.3	106.0	104.1
Yearly average	2.7	3.2	3.7	5.6	7.1
(1979 = 100)	114.04	117.0	119.7	131.8	141.07

* Meaning the basket of currencies used for computing the exchange rate. — Ed. note.

Can we get rid of inflation?

It is not possible to get rid of inflation by means of decrees—it is only possible if the government has enough determination to do its best to eliminate the causes. If, in making a summary of the preceding, we run through the causes to be considered as the most important ones, it will become quite clear that what is involved is questions affecting the whole of the Hungarian economic policy, economic control and management system, and mechanism.

Summing up, we see the main causes of inflation in the following:

1. The *economic policy* pursued between 1973–1978 accumulated a debt stock, the repayment of which could not be guaranteed. This is, unfortunately, not an "eradicable" error. It must be mentioned, because it requires increased efforts in the course of solving the present difficulties.

2. After 1979, the following causes are to be mentioned:

— Wage outflow, monetary and social grants (benefits) have been well above domestic supply. (Strict regulations are instituted, then frequent changes made. However, we have failed so far to establish harmony between household incomes and national economic performance.)

— Lack of *structural transformation of production.* This is explained by the weakness of economic policy in facing conflicts. It manifests itself in the form of a budget redistribution of huge—and not diminishing—dimensions, and the proliferation of subsidies, exceptions, etc. The permanent deterioration of the terms of trade is also among its consequences. A radical transformation of the production structure is needed. Of course, this *requires time* (and is fraught with social conflicts), even if we set about putting it into practice right now. It is to be clearly seen that, if we fail to do so, the technological gap between the advanced world and Hungary will further widen and the fact that we can hardly struggle with inflation represents the smaller risk.

— The lack of *enterprise liquidity, insensitivity to costs,* and the lack of *monetary savings* of enterprises. These are, of course, not independent of what has been listed above, nor of how much the government can be consistent in carrying out earlier made decisions (implementation of the act on bankruptcies, establishment of business banks, and a subsequent transformation of the taxation system).

ПРИЧИНЫ ИНФЛЯЦИИ И ВОЗМОЖНОСТИ ЕЕ ЗАМЕДЛЕНИЯ В ВЕНГРИИ

И. ХАГЕЛМАЙЕР

Пытаясь понять причины инфляции в настоящий момент совершенно нереально предполагать, что результаты хозяйственной политики предшествующего периода (1974–78 гг.) и ее правильная коррекция вызвали в качестве нежелательного эффекта инфляцию. И если это даже отчасти справедливо, то можно предположить, что стремление остановить инфляцию любой ценой значит также и замедление или даже остановку этого процесса дальнейшего развития реформы. При рассмотрении причин инфляции автор указывает на наиболее важные аспекты, связанные с экономической политикой, системой управления экономикой и важнейшими вопросами хозяйственного механизма.

ANNOUNCEMENT

Fourth Congress of the European Economic Association, September 2-4, 1989, Augsburg, West Germany.

Call for Papers

The European Economic Association will hold its fourth annual congress in Augsburg, West Germany, from Saturday September 2 till Monday September 4, 1989. Contributed papers in all areas of economics, including the history of economic thought and economic history, are actively solicited. Submissions should include two copies of the paper and of a one-page abstract, and must be sent *before March 1st, 1989* to the Programme Chairman:

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SWITZERLAND.

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AN INPUT-OUTPUT ANALYSIS OF PRICES IN THE HUNGARIAN ECONOMY BETWEEN 1981–1985

A. SIMON

The paper describes the behaviour of Hungarian prices in a 77 sector input-output model. The parameters of the model are estimated by a cross-section regression analysis using data across the 77 industries of the model.

The paper concludes on the basis of model simulations that prices of manufactures did not follow export prices as policy makers supposed them to do but they were set rather on a cost plus profit basis. Accordingly, the inflation of the 1980-ies is not to be explained by external prices or the exchange rate, not even by price increases of fuels or raw materials but only by wage behaviour.

In recent years several studies have analyzed the new price system introduced in Hungary in 1980, but relatively little attention has been paid to the quantitative implications of its operation. This paper attempts to make up for this deficiency by quantitatively analyzing price trends in the manufacturing industry between 1981–1985.* The model applied is the price block of the INFORUM-type model of the Hungarian economy [4, 6, 9]. First the structure and behavior of the price system will be presented, and then, on this basis the role and weight of the factors leading to price rises between 1981–1985 will be quantified.

In the years indicated, the strategic concept of economic policy about Hungarian producer's prices was that strict central regulation should assure, that prices follow world market prices. The intention behind the idea was to bring firms into a situation, where the profits achieved on the domestic market could not exceed profits that could be realized under the competitive conditions of the world market. It was hoped to import the incentives generated by competition without creating competition itself at home.

Several experts pointed out the various drawbacks of this price regulation and the emergence of effects working against the original intentions [1, 5, 8, 12, 13, 14]. In this article, the price system will not be discussed from a normative point of view. It tries to investigate, how the price system actually functioned between 1981–1985, and compare it with the expected working of the system. An exact comparison may be of

* The article reviews the findings of a research project sponsored by the Ministry of Industry and the Ministry of Foreign Trade. Members of the research team were: Imre *Hercegh*, Tamás *Miskolczi*, András *Simon* and Mária *Veress*.

interest even if we know, that the price system did not develop according to the original expectations in the Hungarian manufacturing industry. It did not work for two reasons. First, because it hurted the interests of both the firms and the authorities. If it had been implemented consequently, it would have introduced an element of insecurity into the financial positions of the enterprises. This was the risk that both parties were afraid of, and this was the reason why the imitation and not the introduction of competition was chosen. Secondly, the "competitive price mechanism" as it was introduced was not an adequate imitation of a competitive market either.

Before dealing with the Hungarian system, let us see, how the real competitive price system works.

Competition and competitive prices

According to the type of the market and the formation of prices, there are two main groups of commodities.

The first group consists of commodities of the *auction-type market*. These goods are transportable at low costs and their quality is easily identifiable. Their market is concentrated usually on commodity exchange markets where a unique world market price is determined. If we have to look for industries that produce mainly goods of this category, we find mining, metallurgy, agriculture, and some activities of light industry.

With some simplification we can say, that in these industries prices are determined by the "invisible hand" of the perfect competitive market and the individual participants of the competition find these prices as given. They are not able to sell at any price higher than the market price and of course it would be senseless to sell at a lower price. They can sell any quantity they produce at the going price. Their competitive position depends on their costs.

The other group of commodities consists of so called differentiated goods. In this group commodities are complex and heterogeneous. Goods of different suppliers are not identical and the differences can not be captured and measured by simple comparisons of their qualities. The comparison becomes particularly difficult, if beyond the physical characteristics of the products, such factors as reliability of supply, customer service, etc. are to be taken into account. The notion of a unique world market price, exogenous to the seller, does not exist here. Any price, that is set by the seller, is a world market price in some sense. He is able to sell on this price, only the quantity sold will differ depending on the price.

How are prices of differentiated goods determined? Practice has shown, that the best information the firms can base their decision on are their own cost data. They usually add a constant, "reasonable" markup to their costs to set the price. The competitive position of the firm will reveal itself in the quantity it is able to sell. If its price is too high relative to the quality of its good it will get out of business in the longer run.

Simulation of competition and competitive prices

To what extent can the Hungarian price system be considered a simulation of a competitive price system?

As in the real competitive market, it is useful to distinct between two major categories of goods. In the first category, within the group of homogeneous goods, world market prices are easy to define and here the "competitive price system" worked rather well. World market prices determined domestic prices partly automatically by the rules of price formation, and partly through administrative prices. In both the area of free sectors and that of administrative prices the authorities had much role in preserving the profitability positions of the firms, either by deviating from the basic principles of price formation or by compensating financial schemes. In summary we can say, that in this category of goods the price system did simulate the competitive world market price system, though the effects of competition were largely mitigated by an accommodating tax and subsidy policy.

In the second category, that of differentiated goods, the pricing behavior of Hungarian firms is very similar in form to that of the enterprises operating in a competitive environment. On both markets the firm adds a stable, "reasonable" rate of profit to its costs when determining prices. The firm in a competitive environment does not dare to charge a higher profit, because of fearing from the competition. He has to assume, that his competitors have the same rates of costs, and if he overpriced his good he could not remain on the market in the long run. His fear is based on the knowledge that he does not monopolize any technical or organizational know-how against his competitors that would allow him to keep a higher profit rate.

The Hungarian firm does not dare to calculate a higher than usual profit rate either, but not because he would be eliminated by competition. He is well protected against such risks. He exerts a voluntary constraint, because he is exposed to the risk of his profits being taxed away. The reason of this uncertainty is, that in lack of competitors it is never possible to tell, whether his higher profits are results of his extraordinary achievements or his monopolistic market power. In this system the costs of the firm serve as arguments in the bargaining with the authorities to show, that he charges not more, than the reasonable price. It is very doubtful, whether he can increase profits by cutting costs. In extreme cases, even a "dilution of costs" may be in the interest of an enterprise.

In the policy to preserve constant profitability the enterprise gets much help from the authorities, who fear from the destabilizing effects of a bankruptcy and the drop of output during the reorganization of a firm. Thus if prices cannot be kept at a level that assures profitability, they will adjust taxes and subsidies selectively.

Comparing price behavior in the Hungarian economy with that of a competitive market, we can say, that the formal similarity does not mean that the price system smuggled some elements of market competition into the economy. Prices will never create efficiency themselves, as technical development is forced out not by prices, but by competition on the real market.

Though the Hungarian system of free or at least quasi-free prices does not operate under competitive conditions, it raises the same problems of economic policy, as the free market does. The drawbacks of free competition has to be accepted without enjoying its advantages. The same dilemma of inflation or restriction, growth or balance of payments equilibrium has to be solved by the policy makers every year, as it is in economies of competitive markets.

The model

Data

The model uses a 77 sector input-output table of the Hungarian economy, compiled and published by the Central Statistical Office (CSO) for the year 1981. This statistical base forced us to some simplification in calculating costs, having to assume a uniform cost structure within an industry. For the rest of the time period estimated input output tables were compiled by ourselves. Components of value added were derived from the data bank of balance sheets in the Ministry of Finance and the more aggregated data of the national accounts statistics prepared in the CSO. The time series of input-output coefficients were estimated by the real-side block of the INFORUM-type model. The method of estimation is given in [6]. The statistical publications of the Ministry of Foreign Trade provided sources for the data relating to financial bridges in foreign trade. The CSO was the source of price indices for industries.

Commodity groups by pricing principles

From the point of view of price formation the model distinguishes among three types of goods: products with prices set administratively, those taking prices of the world market and those being priced on a cost-plus basis.

a) Administrative prices

In this category prices are centrally determined. They may set independently from costs, the difference between cost and price being covered by the state budget. Here belong energy, some raw materials mostly of agricultural origin, as well as some consumer goods and services. Authorities are free to set prices here, but they are responsible for the supply. They have to take care of the profitability of production of these goods by finding the appropriate amount of compensation for possible losses built in the price. The responsibility for supply can frequently be transferred to the producing firm. If the firm produces both free-priced and fix-priced goods, it is usually ready to take over the function of the state budget: it makes the income redistribution within its own budget. It covers the loss on one good from the surplus on the other. Its readiness to do so is a consequence of its particular, dependent relationship to the organizations handling the state budget. Anyway, the firm does not strive to exploit the profit-generating possibility allowed by its monopoly power. The state budget has to interfere only if the firm does not possess cost bearing goods of the its cost-diverting possibilities have been exhausted. There is no doubt about it, that this behavior of the firms makes the system more flexible, though the drawbacks of this voluntary loss-making production are evident by considering the assortment, terms of delivery and technical standards of these goods.

What has been described is important for the model because it allows to treat some industries as if they belonged to the group where prices are set freely, though their basket is mixed. This redistribution mechanism of profits assures, the few prices that are set centrally have no effect on the average profit of the industry.

b) World market type prices

In some industries producing basic materials, were production is sufficiently homogeneous and can be easily identified with exported or imported goods, the principles of the "competitive price mechanism" prevail. The firms are exposed to effects of the world market, and in the years their fate depends on the willingness of the authorities to bail them out. In the industry of ferrous metals such a dilemma has emerged recently. Finally, the decision making on prices do not differ too much from that on administrative prices.

c) Cost-plus prices

In most industries prices are set on a cost-plus basis. The firms expect their costs to be covered with some profit added. This principle prevails in most of the manufacturing industries, independently of the official classification, that divides the economy into the "competitive" and "non-competitive" sphere. Some "rules of the game" were developed in industries producing for exports to abide the official rules formally, but prices follow costs, and not export prices. But how are export prices themselves determined? Are they exogenously given to the firm, or is product differentiation deep enough to allow the firm to follow an independent price policy, based on costs, similarly to the domestic market? The model assumes a behavior that is between these two extreme possibilities. Export prices are exogenous for the model, but costs are proven to correlate with these prices.

Equations of the model

Every variable in the model is a vector, the elements of which refer to industries. An asterisk indicates multiplication of vectors by components, a dot denotes scalar product of two vectors.

The index of *producer's prices* is the weighted sum of price indexes formed according to the various price formation principles:

$$pq = sc*pc + se*pe\$com + sm*pm\$com + sa*pa \tag{1}$$

where

pq — index of producer's prices,
pc — cost-plus type price index,
ps$com — price index following export prices,
pm$com — price index following import prices,
pa — administrative price,
sc, se, sm, sa — weight of individual price categories within an industry

Prices of competitive goods follow foreign trade prices modified by "financial bridges". It was assumed, that the price index of producer prices is composed to the extent of 70 percent from the index of foreign trade prices and to the extent of 30 percent from the producer's price index of the preceding year. Prices thus only partially adjust to export prices. The weights were established on the basis of a series of experiments with regression analysis. This formula turned out to give the best fit between computed price indices and actual ones.

$$pe\$com = 0.7*pe\$*rf\$*(1 + vte\$) + 0.3*pe\$com_{-1} \tag{2}$$
$$pm\$com = 0.7*pm\$*rf\$*(1+mt\$) + 0.3*pm\$com_{-1} \tag{3}$$

where

pe\$ — dollar based price index of exports to the dollar area,
pm\$ — dollar based price index of imports from the dollar area,
rf\$ — exchange rate of the forint to the dollar (scalar),
vte\$ — rate of subsidies and taxes (—) on exports to the dollar area,
mt\$ tariff rate on imports from the dollar area.

The formulation of the assumption on *cost-plus* type pricing raises several kinds of concern. Should pre-tax or the after-tax profits considered as target rate for the firm? Should it comprise the part of depreciation allowance remaining with the firm? How should we handle preferential treatments equivalent to profit in some sense (e.g. so called wage preferences)? What should we take as the denominator of the profit rate? Should it be gross or net output, yearly output or average of a few years?

The period 1981–1984 was relatively easier to handle. In this period, although the rates of tax and subsidies changed, the tax system itself remained essentially unchanged. For this period it was assumed, that the firms made efforts to stabilize pre-tax profits. Neither obstacles to the discretionary use of profits, nor special treatments were taken into account as factors modifying profits. This means, that we assumed, that profits have the same worth, independent of the central policy that constrains or fosters its spending.

In 1985 a substantial change was made in the tax system. Tax rates of profits were changed and the depreciation allowance, 40 percent of which was taxed away before, was decided to be tax free. For this year, the financial position of the firm was assumed to be unchanged in the case, if the sum of its after tax profits and depreciation allowance equaled that of the previous year.

As to the denominator of the profit rate, several indicators could be used: capital, wages, value added, etc. In the model we set out from the prevailing practice: both the firm and the price authority relate profits simply to gross sales and they observe the development of this indicator.

Finally, it had to be decided what is to be considered as a stable rate of profit. In general we assumed that firms try to preserve the rate of profit of the previous year.

$$pc = vjd_{-1} *pc + kd*(cost+cor) + vtd*pc \tag{4}$$

where

cost — unit costs: $p.A + (va*cap + vw*emp*vwt)/q$

cor — correction multiplier of material input costs by industries,[a]
vtd — net taxes on goods sold domestically,
A — matrix of input coefficients,
p — price index on the domestic market (average of producer's prices and import prices)
va — depreciation allowance per unit of fixed capital stock,
cap — fixed capital stock
vw — wage cost per employee
emp — employment
vwt — rate of wage taxes
q — gross output at 1981 prices
kd, k$, krb — charging factors of costs[b]

As regards the profitability of exports, complete stability could not be assumed, but an effort at a certain stability shows up here too. As it will be seen, profit only partially follows the value that can be calculated as the difference of price and costs allocated by using unchanged charging factors. Before formulating this behavior, let us make some remarks on the coefficients, called charging factors.

The calculation of charging factors was based on data supplied by the firms regarding profitability of sales to different destinations. Although the limitations of the input-output database forced us to assume the cost structure within an industry to be independent of the direction of sales, the available data on different profit rates by destination allowed us to charge total costs selectively on different sales. The cost charging coefficients showed marked fluctuations from year to year. Regression analysis has shown the behavior behind these fluctuations. Cost charging factors seemed stabilizing earnings on exports versus domestic sales. Whenever export prices went up, more costs were charged on exports and vice versa. We do not know, how much of this phenomenon could be explained by the behavior of the firm that allocates costs among markets depending on how much they are able to bear. Probably most of the reason is purely statistical: price indexes cover changes in qualities as well, and higher quality can be produced only at higher costs. Whatever the reason, the relationship is coded into the model and it works independently of its explanation. The following equations have been estimated:

$$\mathrm{vje\$} = a + b * \mathrm{vje\$com} + c * \mathrm{vje\$}_{-1} \tag{6}$$

[a] The INFORUM-type model produces the missing observations of the time series of input-output coefficients by interpolation, assuming equal rates of changes across a row. This method leads in some industries to statistical discrepancies. These residuals show some trend in individual industries, but for the economy as a whole they are around zero.

[b] They define how much of total costs in an industry are charged to the different directions of sales: domestic sales, exports to the dollar area, exports to the rouble area. They add up to 1 by definition.

$$\text{vjerb} = a + b * \text{vjerbcom} + c * \text{vjerb}_{-1} \tag{7}$$

$$\text{vje\$com} = \text{k\$}_{-1} * (\text{cost} + \text{cor}) / \text{pe\$*rf\$} - \text{vte\$}, \tag{8}$$

$$\text{vjerbcom} = 1 - \text{krb}_{-1} * (\text{cost} + \text{cor}) / \text{perb*rfrb} - \text{vterb}, \tag{9}$$

where

a, b, c	— regression coefficients, $0 < b, c < 1$,
vje$com, vjerbcom	— profit rates of sales to the dollar and the rouble area, assuming charging factors of the previous year,
vte$, vterb	— export taxes minus subsidies
vje$, vjerb	— profitability of exports,
rfrb	— exchange rate of the forint to the rouble (scalar)

The equations formulate the behavior of profits, that adjust only partially to the values calculated on the basis of unchanged charging factors. This is possible only if actual charging factors adjust in the way explained above.

The estimation results of (7) and (8) show the significance of this relationship *(Table 1)*.

The charging factors are determined by their definitional identities.

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Table 1

Estimation results of equations for export profitability
[Equations (5) and (6)]

Year	Profit rate in exports to the dollar area				Profit rate in exports to the rouble area			
	coefficients of			R^2	coefficients of			R^2
	constant (a)	vje$com[a] (b)	vje$-1[b] (c)		constant (a)	vjerbcom[a] (b)	vjerb-1[b] (c)	
1982	.02	.21	.46	.655	.04	.38	.32	.778
	(1.96)	(1.74)	(3.29)		(1.01)	(2.45)	(4.56)	
1983	.00	.55	.47	.728	—.03	.65	.51	.889
	(0.08)	(3.36)	(2.33)		(0.98)	(4.98)	(3.21)	
1984	.68	.73	—.05	.675	.18	.71	.15	.905
	(.40)	(3.23)	(0.22)		(0.96)	(7.88)	(0.66)	

[a] Profit rate assuming unchanged charging factors
[b] Profit rate of last year
Remark: Coefficients are estimated by ordinary least squares. Figures in parenthesis indicate t-statistics of the coefficient.

The charging factors are determined by their definitional identities:

$$1 = vje\$ + k\$ * (cost + cor) / pe\$ + vte\$ \tag{10}$$

$$1 = vjerb + krb * (cost + cor) / perb + vterb \tag{11}$$

$$kd(q\text{-}e\$\text{-}erb) + k\$.e\$ + krb.erb = q \tag{12}$$

where

e$ — exports to the dollar area in constant (1981) forints
erb — exports to the rouble area in constant (1981) forints
q — total sales at constant (1981) prices.

In recent years it has become ever more obvious that level of wages is not a parameter to be freely used by policy makers, but a variable living an increasingly independent life. While in the course of the price reform of 1979–80 carried out by raising consumer prices enormously, the leadership itself determined the level of wage hike that compensate for losses in purchasing power. In recent years however, wages became to develop autonomously and consumer prices had to be adjusted to constrain total consumption.

Similarly to producer's prices, wages develop according to the behavior of firms and employees. Every year there is a rate of increase of nominal wages which both firms and employees expect to be the norm across the economy. If the firm does not raise wages at this rate, its employees will leave. Firms and employees develop these common expectations, of course, on the basis of experiences in preceding years. This is not a single year, but several years. This is that makes fighting against inflation difficult among other things. In the short run, a restriction of demand results in a drop of production only. Curbing wage and price rises requires a longer deflationary period.

This hypothesis about the behavior of Hungarian wages relies on experiences of market economies. The short Hungarian experience is not sufficient to verify a stochastic relationship built on this hypothesis. Instead, a simplified, pragmatic assumption was applied in our model: the rate of growth in wages follows the rate of the previous year, independently of consumer prices. However, if prices increased in a year so much that caused real wages to drop by more than one percent, nominal wages would catch up by means of compensating wage policy.

If $rw/rw_{-1} > 0.99$, then (13)

$$vw = vw_{-1} * vw_{-1}/vw_{-2},$$

else $vw = 0.99 * cpi$,

where

rw — real wages (vw/cpi)
cpi — consumer price index.

The *price index on the domestic market* is a weighted sum of producer's prices and domestic prices of imports.

The indexes of the domestic prices of imports on 1981 basis:

$$pm\$d = pm\$ * (1+mt\$)*rf\$ \,/\, pm\$(1981) \tag{14}$$

$$pmrbd = pmrb * (1+mtrb)*rfrb \,/\, pmrb(1981) \tag{15}$$

where

pmrb — rouble-based price index of imports from the rouble area,
pm$ — dollar-based price index of imports from the dollar area
mt$ — import duty,
mtrb — import taxes and subsidies (—) on imports from the rouble area,
pmrbd, pm$d — indexes of domestic prices of imports (1981 base)

The variable mt is exogenous for the model, but mtrb may be modeled using various assumptions. Presently the model assumes, that domestic prices of imports from the rouble area are determined to be equal to the rest of domestic prices, and mtrb has the role of adjusting prices.

Index of average domestic prices:

$$p = (pq*(q\text{-}e\$\text{-}erb) + pmsd*m\$ + pmrb*mrb)/q\text{-}e\$\text{-}erb+m\$+mrb) \tag{16}$$

Forecast and links to the INFORUM-type model

The model is part of the INFORUM-type model of the Hungarian economy. There are several exogenous variables in the price model, that are endogenous for the model augmented with the real sphere block. These variables are the following:

e$ — exports to the dollar area,
erb — exports to the rouble area,
m$ — imports from the dollar area,
mrb — imports from the rouble area,
q — gross output (sales),
emp — employment,

cons — consumption,
cap — capital stock,
A — input-output coefficients.

Forecasting is made in two steps. Values for the above variables are calculated by the real block of the model. This can be done independently from the price model, as there is no feedback from the price model to the real-side model presently. Two channels of feedback are considered to be included in the near future: prices into consumption and profitability to exports. The former relationship is plausible, the existence of the latter is not yet confirmed.

As a next step we give exogenous forecasts for world market prices and the exchange rate of the forint. This would determine costs of imports and producer prices of some base materials. Then administrative prices have to be determined. If the purpose of the calculation is a forecast, and not a simulation of effects of policy decisions on prices, the forecast of administrative prices relies on expected world market prices for traded goods and calculated costs for certain non-traded services.

Finally the cost-plus prices are calculated by the model with all their feedback.

Export prices or cost-plus pricing?

Using the model, we are able to give a quantified answer, whether prices of manufactured goods followed export prices as prescribed in the period 1981–1985 or they behaved according to the cost-plus pricing principle.

For the 24 manufacturing industries both types of prices were calculated. Regression equations were set up for actual prices explained first by prices calculated on the principles of the "competitive price mechanism" and then by prices calculated on the basis of cost-plus pricing. The regression parameters were estimated on the basis of cross-section data, observations given by data of manufacturing industries. Calculations were repeated for every year between 1982 and 1985.

Table 2 shows an improvement of fit in time. The reason for that is purely technical: the observed data are indexes with a 1981 base. Yearly changes are cumulating in this index by definition. While random changes may extinguish each other with time, changes arising from the functional relationship add up. Therefore, the further we go from the base year, the greater the ratio of explained changes to random fluctuations.

The results of *Table 2* indicate, that the cost-plus pricing assumption explains much better actual behavior. Though "competitive" prices correlate with actual prices,

Table 2

Estimation results of equations for pricing

Year	Explaining prices by the competitive price mechanism of equation (2)			Explaining prices by cost-plus pricing of equation (4)		
	coefficients of			coefficients of		
	constant (a)	pe$com (b)	R^2	constant (a)	vjerbcom (b)	R^2
1982	93	.08	.023	.75	.27	.166
	(8.39)	(0.70)		(5.75)	(2.08)	
1983	.87	.17	.155	.36	.65	.578
	(10.0)	(2.01)		(2.88)	(5.49)	
1982	.87	.22	.164	.21	.80	.697
	(7.90)	(2.08)		(1.67)	(7.11)	
1983	.70	.41	.306	.24	.77	.699
	(4.81)	(3.11)		(1.88)	(7.14)	

Remark: Coefficients are estimated by ordinary least squares. Figures in parenthesis indicate t-statistics of the coefficient.

the relationship is much weaker, than that between prices and cost-plus based calculations. Explaining prices by both computed prices, competitive prices loose their significance. Results of this regression are not reproduced here.

Explanation of the inflation process 1981–1985

We tried to separate the main factors causing the inflation of the years 1981–1985 by comparing various ex post simulation results of our model. The simulations differed by some crucial exogenous inputs, all of them considered as candidates to be the scapegoat in causing inflation. The summary results of the various runs are presented in tables.

Table 3 shows a comparison of simulated prices calculated on the "competitive pricing" principle and cost-plus pricing. As it is to be seen, our model of cost-plus prices follow actual prices much closer, than prices calculated according to official prescriptions.

In the scenario presented in *Table 4* administrative prices, foreign trade prices and most of the financial bridges related to trade were assumed to be unchanged during the whole period. The financial bridges of imports from the rouble area were assumed to take up values that set domestic prices of imports equal to producer's prices. In

Table 3

Aggregate results of simulations using actual values for exogeneous variables

(percents)

	1981	1982	1983	1984	1985
Producer's price index	100	104.4	111.1	115.1	121.2
(difference from actual)		(0.0)	(0.0)	(—0.2)	(1.2)
Forint price of dollar exports	100	98.5	102.8	107.8	107.9
Forint price of dollar imports	100	99.1	107.2	113.8	118.9
Forint price of rouble exports	100	103.5	108.8	112.3	116.2
Material costs[a]	65.1	67.5	72.5	75.0	78.9
(difference from actual)		(—0.2)	(0.8)	(0.2)	(1.3)
Wage costs	19.3	20.0	20.1	20.9	22.4
Depreciation allowance[a]	4.9	5.0	5.3	5.4	5.4
Other costs[a]	1.2	2.0	2.9	2.9	—1.5
(difference from actual)		(—0.2)	(—0.3)	(—0.2)	(—1.0)
Gross profits[a]	9.5	9.1	9.4	10.0	14.4
(difference from actual)		(0.2)	(—0.1)	(—0.1)	(0.6)
Average (domestic + export) price	100	103.6	110.3	114.2	119.6
(difference from actual)		(—0.2)	(0.4)	(—0.1)	(0.9)
Producer's price	100	102.7	108.7	112.6	117.9
(difference from actual)		(—0.7)	(—2.4)	(—2.7)	(—2.1)

Remark: Differences from actual are given for the endogeneous variables.
[a] Using the assumptions of the 'competitive price mechanism'

Table 4

Aggregate results of simulations using unchanged values for administrative and foreign trade prices

(percents)

	1981	1982	1983	1984	1985
Producer's price index	100	100.8	104.0	105.2	108.7
(percentage rate of growth)		(0.8)	(3.2)	(1.2)	(3.3)
Material costs[a]	65.1	65.0	66.9	67.3	69.7
Wage costs[a]	19.3	20.0	20.1	20.9	22.4
Depreciation allowance[a]	4.9	5.0	5.3	5.4	5.4
Other	1.2	1.5	2.6	2.2	—1.9
Gross profits[a]	9.5	9.1	8.5	8.6	12.2
Average (domestic + export) price	100	103.6	110.3	114.2	119.6

[a] Per unit of gross output at prices of 1981

reality this equalization is not quite as automatic as that. This assumed mechanism probably amplifies the effect of any exogenous shock on producer's prices.

In the scenario of *Table 5* foreign trade prices were assumed to be constant as before, but administrative prices take actual values. To capture the effects of prices of base materials on the general price level, administrative prices were interpreted more broadly than declared officially. Ferrous metals, aluminum, sawn wood and plywood were included here too. Prices of these commodities were actually set more or less administratively anyway.

Table 5

Aggregate results of simulations using unchanged values for foreign trade prices and actual values for administrative prices

(percents)

	1981	1982	1983	1984	1985
Administrative prices	100	111.8	119.4	122.0	129.2
(percentage rate of growth)		(11.8)	(6.8)	(2.2)	(5.9)
Direct effect on total price index	100	101.9	102.9	103.3	104.0
(percentage rate of growth)		1.9	1.0	0.4	0.7
Producer's prices	100	104.5	110.0	112.1	116.5
(percentage rate of growth)		4.5	5.3	1.9	3.9
Material costs[a]	65.1	67.9	71.6	72.7	76.5
Wage costs[a]	19.3	20.0	20.1	20.9	22.4
Depreciation allowance[a]	4.9	5.0	5.3	5.4	5.4
Other[a]	1.2	1.7	2.8	2.4	—2.4
Gross profits[a]	9.5	9.2	9.1	9.7	13.6
Average (domestic = export) price	100	103.8	108.9	11.1	115.5

[a] Per unit of gross output at prices of 1981

Remarks: Administrative pricing was assumed in sectors of energy, metallurgy and sawn wood.

By comparing results of different scenarios the *ceteris paribus* impacts of some variables can be calculated as a coefficient. One of these scenarios, where only the energy prices have changed, is not reproduced here, but its results were used below. In *Table 6* the effect of a 1 percent devaluation of the forint on the level of producer's prices is broken down by the contribution of various commodity groups. It was assumed, that administrative prices behave as competitive prices, i.e. they completely adjust to the value of the foreign exchange.

As it is to be seen from the table, an increase in foreign trade prices has a cost-push effect mainly through the prices of raw materials. There is no pull effect from the

Table 6

Effect of a one percent devaluation of the Forint against hard currencies

	Percent
Direct effect of energy prices	0.12
Tottal effect of energy prices	0.13
Direct effect of metal prices	0.02
Total effect of metal prices	0.03
Effect of admin. and/or compet. prices	0.30
Effect of prices of other goods	0.10
Total effect of devaluation	0.40

higher prices of the international competitors, as it is frequently assumed on the basis of the "competitive price mechanism".

Studying the data, we can see, that in 1985 we would have a 3.3 percent inflation even if foreign trade prices (in forints) were constant and administrative prices were frozen. This indicates an strong autonomous inflation in the Hungarian economy. The actual inflation of 4.1 percent came about in conditions, where export prices grew somewhat slower than, administrative prices somewhat faster than, and import prices at the same rate as the average domestic price level. By and large exogenous price increases went along autonomous inflation, neither accelerating, nor decelerating it. Similar statements are true for other years, with the role of exogenous factors varying somewhat in time. *This means, that the only source of inflation in the Hungarian economy have been primary costs of domestic origin: wages, taxes and profits.* With this conclusion we reached the limitations of the model: only a sketchy hypothesis was made about wage behavior and no attempt was made to tell which portion of taxes is passed through to prices. An analysis of these factors would perhaps explain the fluctuation in the rate of inflation, that amounts to one or two percentage points a year.

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АНАЛИЗ ЦЕНООБРАЗОВАНИЯ В 1981—1985 ГГ. С ПОМОЩЬЮ МОДЕЛИ МОБ

А. ШИМОН

Функционирование венгерского ценового механизма описывается в форме модели с применением межотраслевого баланса 77 отраслей. Оценка параметров функции модели производится методом регрессии на основе данных отраслей профилирующего характера. Автор констатирует, что в последние пять лет производственные цены отраслей перерабатывающей промышленности возрастали пропорционально не экспортным ценам, как это предполагалось в соответствии с первоначальной концепцией механизма цен, а пропорционально затратам. Поэтому наблюдаемую инфляцию нельзя объяснить ни формированием цен внешнего рынка, ни курсом форинта. Можно констатировать также и то, что рост цен на энергию и сырье не превышал средних темпов инфляции. Таким образом, повышение цен должно объяснятся в первую очередь положением в области заработной платы.

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THE PREHISTORY OF THE REFORM OF HUNGARY'S BANKING SYSTEM

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The 1968 economic reform focused on the issues of prices, regulation, and stimulation, while it treated the reform of the organizational-institutional system as a secondary question. This may sufficiently explain the fact that the decentralization of monopolist enterprises was postponed and the transformation of the administration's organizational system was not even scheduled. This answer, however, is not fully true in the case of the financial organizational and institutional system. As a matter of fact, it was the functions and role of just these areas, which the reform substantially reappraised. The issue of th reform of the banking system (including the establishment of a capital market) was raised around 1968. Only a few researchers were involved in these debates; the issue was never considered as a possible alternative at the policy-making level. The reform of the banking system and the concomitant gradual establishment of a capital market would have required a substantial change in economic policy.

The area where Hungary's 1968 economic reform brought the least comprehensive and consistent break with directive planning was the control and regulation of investments and capital flows. Experts participating in the elaboration of the reform more or less agreed, too, that enterprise investment decisions should be limited, to the so-called dynamic reproduction, while investments over that should be decided upon by the central authorities. This conception obviously contradicts the establishment of instruments, institutions, and the comprehensive system of such financial intermediation, which is decentralized and based on the economic agents' business decisions.

A strong argument against a change in the banking system was the postponement of organizational-institutional changes in other fields of the economy. In this situation it is questionable indeed whether it is worth-while to go too far ahead in only one sector, in the banking system. Actually, this question stood in the central position in the first wave of banking debates, which were going on in economic journals in the late 1960s and early 1970s.

When discussing the role of the National Bank of Hungary (NBH), István *Hagelmayer*, the best advocate of the urgent need for the establishment of a two-tier banking system, argued: "The essential problem is that this bank performs central banking and commercial banking functions at the same time, while the separation and then the establishment of a linkage between these two functions have not been done." In practice the NBH does not fulfil its central banking tasks, whereas in its credit-granting activity it operates without business risk and quantitative, institutional constraint. "... the 'central banking seed' of the sole bank has not had—and cannot have—any influence on the volume of credits." At the same time, an economy that wants to "turn to the market" cannot dispense with the participation of the central bank in the control of economic developments through credit policy. The unlimited supply of credit and the non-existence of liquidity problems lead to riskless banking activity. This obviously results in the absence of responsibility. "... the active credit policy devoted to influencing the development of the economy should not renounce the macroeconomic quantitative control of credit..."

Since the preliminary quantitative determination of the NBH's credits would be too rigid, the solution lies, instead, in separating, then establishing a link between the central banking and commercial banking functions. "...we should establish the central bank with a function devoted to influencing the business cycle and, separately, the commercial bank or the system of commercial banks which would pursue business policies under conditions controlled by the central bank."* The commercial banks would essentially operate in a sectoral system.

The proposal apparently emphasizes the rational separation of functions or macro- and micro-decisions, and not the interbank competition or the elimination of their profile-constraints.

The opinion of Miklós *Riesz* was in sharp contradiction to that. He regarded the centralized financial system as a definite advantage of a centrally planned economy—indeed it has a greater role and significance in more market-oriented economic management. This is the only way in which it can fulfil its increasingly important controlling function.

According to his reasoning, although the arguments for two-tier sectoral banks are logical from a micro-level point of view, the overview of a sectoral bank is not sufficient in the case of such investments, and the attached credits, which have a significant impact on the economic structure. Moreover, he continues, there are several investments, and not even in small volumes, which cannot be grouped into the sectoral system. Therefore, in practice, a central investment financing institution would also be needed. In this way the sectoral banks providing working capital credit would only finance smaller investments. In this case, however, the standpoint according to which the concentration of short and long-term credits within a sole bank "excessively enlarges" the bank can no longer be maintained.** In his view, the problems to be resolved in the financial system are not organizational ones.

The third concept, nearest to practical matters, conceives the whole debate about banking as a conflict of two points of view. The first considers credit as a determinant element of economic control and wishes to attain a stronger assertion of central

* See István Hagelmayer [8] and [9 p. 172]

** See Miklós Riesz [16 pp. 336–370]

intentions by transforming the banking system. The second one holds that the decentralization of the banking system helps to put business consideration to the fore, and to bring about closer and better harmony between banking and the market processes.

Tamás *Bácskai* agreed with the objectives of the first idea, but according to him achieving these objectives does not make the substantial transformation of the banking system necessary. "In respect of the uniform interpretation and behaviour, information flow, overview, and the quickness of interactions between the central banking and commercial banking functions, the sole institution has great advantages with regard to the enforcement of central policies." [3] In the prevailing indirect control and management system where, as Ernő *Huszti* and Béla *Szajáni* point out, credit really plays a transmission role, "... according to experience, the monetary system, in many respects, has a subordinated position within the financial system (and the financial system does not have adequate weight in the decision-making hierarchy, either), and it is often subject to pressures to lend by the fiscal system; the monetary system does not dispose of those special instruments, which could facilitate the efficient implementation of monetary policy." [6] Under such circumstances, the advantages of a two-tier banking system are really questionable.

Retrospectively, it is already clear that—although the adequate financial system for indirect management is the one-tier banking system—the unchanged financial organizational and institutional system became one of the most important factors preventing the post-1968 economic mechanism from gradually being transformed into a genuine decentralized economic mechanism. The absence of a capital market, which at first was actually the consequence of an imaginary model that maintained central control over the majority of investments, gradually became a reason for the maintenance of widespread central redistribution, for the frequent correction of regulations, as well as for the emergence of a peculiar institutional system—the so-called "investment purchasing power" control.

Already at this time, a few economic researchers warned that without introducing a capital market and the concomitant long-term profit motivation, the reform would not fulfil the expectations associated with it, and the shortage economy could not be eliminated. Therefore the proposals did not recommend an isolated banking reform, but a comprehensive institutional reform.* This idea, however, did not bring about any strong reaction—even among experts. This was probably because at this time it was not the gradual development of the reform, but recentralization that was on the agenda.

Giving up the idea of establishing a capital market as well as the reform of the banking system, however, made the operation of the financial system disfunctional

* For more details see [12], [17], [18].

both on macro (money supply or, rather, credit supply control) and micro (indebtedness, capital market-simulating constructions) levels. These problems, since substantial changes were rejected by the central authorities, arose as technical questions of financing and, of course, proved to be insoluble. Even in the first years of the reform, more or less collaterally with the above-mentioned debates, the inherent contradictions of the financial system started to appear. While, not least as a result of the reform, the rate of economic growth was high investment cycles continued to exist. In the course of the strong animation, both enterprise and state investments grew rapidly—in fact, faster than planned. The enterprises obtained the necessary external resources from credit, usually direct from the state budget. This, however, had two consequences. The development funds of those enterprises who financed their investments mostly by credit started to be exhausted rather soon. In this process, it was apparently impossible to recognize to what extent the insufficient competitiveness and to what extent the contradictions of the financing and decision-making systems were responsible for the indebtedness and the long-lasting burdening of the development fund of an enterprise. The declared intention of central management concerning investments, coupled with the then prevailing conception of self-financing, excluded the institutions of long-term capital acquisition from the market as well as the capital flows among economic units. Therefore, besides credit, only budgetary resources could be regarded as external resources—actually not only in the so-called classical fields of state financing, but in a much wider circle than had been previously—before 1968—expected. The contradictions between the credit system based on the self-financing of fixed and working capital and the rules of the money-credit mechanism became apparent very early. [16]

Meeting the demand for money of the then (still) rapidly growing economy was hindered by the limited borrowing possibility of the enterprise sector (i.e. limited by the development fund). Thus their demand for money was covered by the budget, being one of the reasons why the state budget necessarily started to run into deficit. The deep intervention into the investment system through the budget also fitted into the contemporary idea of the central control of investments.

The fear arising from the mass enterprise indebtedness—in which the problems caused by the regulation are inseparably mixed with the consequences of the weak enterprise performance as well as with the debt coming from financially irresponsible investments—, the wider-than-intended budgetary financing, and the relatively limited role of credit all justified the comprehensive examination of the issue of capital flows. At the turn of the 1970s a workteam was set up to analyze the situation concerning the inter-firm flow of capital. The committee found that the volume of horizontal capital flows was extremely low and this was not based on market principles. The institutions necessary for moving the development funds among enterprises were missing, the interest system was inflexible, and securities did not exist at all. The committee proposed the strengthening of inter-enterprise capital movements, the creation of adequate conditions for their regulation, the introduction and legalization of commercial credit and bills of exchange, as well as the gradual introduction of bonds. The application of shares was rejected on an ideological basis, while the reform of the financial institutional system was not scheduled either. In order to rationalize the state development policy, to eliminate the deficit of the state budget, and to supplement the missing institutions of long-term capital acquisition, the committee suggested that, besides reducing the provision of free capital, special credits (loans), repayable partly or fully from pretax profit, be granted for investment financing. [14]

In practice, however, instead of the proposed cautious progress, the centralization of capital allocation, the case-by-case treatment of problems of large enterprises, and the strengthening of sectoral coordination came into prominence. But already in the course of the preparatory works for the Fifth Five-Year Plan, which covered the period between 1970–1975, modernization of the state support system of investments as well as the extremely limited capital acquisition possibilities of dynamic enterprises (at that time the profitability aspect was still frequently omitted) were raised again.

The introduction and extension of the new schemes (state loan, support-advancing credit, capital provision after which a rent is to be paid) were nevertheless not connected to the reform. As a matter of fact, they were motivated by the earlier unimaginable deficit of the sate budget. Thus the investments, which had previously been financed mostly from budgetary resources, were taken out of this sphere.

Each of the new schemes was refinanced by the credit sphere. In technical terms, this brought a considerable improvement in the budgetary balance in the short run, while the intensity of state intervention into the investment and capital allocation systems was practically unchanged.

However, the expansion, which did not step up export capacities and was based on CMEA autarky, while basically financed from external sources, sooner or later had to lose its momentum. (The economic leadership was aware that a dynamic economic development without an intensive structural adjustment to the world market is simply not sustainable. In spite of this, the party resolution of October 1977 did not recognize that this change apparently could not be achieved within the frameworks of the given mechanism, moreover it considered the central selection in physical terms as the way of successful adjustment.)

The turn of the economic policy in 1979 postponed the investment expansion indefinitely. At the same time, the idea that the adjustment to the world economy can be ensured by spectacular investments was abandoned. Although at that time a new and substantial reform of the economic mechanism and the transformation of the organizational and institutional system were still not seriously taken into account, the authorities wanted to ease the rigidities of capital allocation by any means. (With suddenly and considerably narrowing investment possibilities, a significant structural change obviously cannot be implemented otherwise.) For the elaboration of a conception to improve the macroeconomic management, a team was set up. According to its itinerary, it investigated the obstacles standing before the increase of the role of credit. From contributions prepared for the team, it turned out that even asking the question in this form was inappropriate. Increasing the role of credit *in itself* is not a soluble problem. In a situation where credit policy is subordinated to the essentially physical objectives of the macroeconomic plans, where credit lines are broken down to sectors and—informally—even deeper, where credit policy is subordinated to fiscal policy too, where the banking system is centralized and monolithic, where banks are exempt from risk and responsibility, and enterprises are at the mercy of the banking system, the meaningful increase of the role of credit is impossible. In order that credit could play the role designed for (and expected of) it, the transformation of all these factors and the improvement of the organizational and institutional background would be necessary. However, the intention to carry out such a substantial change was unable to make its way.

At the same time, some changes nevertheless happened. Perhaps the most important of these was the establishment of so-called small financial institutions. The initially extremely cautious attempt to keep back economic growth (starting at the turn of 1977–1978) gradually led to an increasingly strong restriction. Paradoxically, the restriction ensured favourable ground for the slow but continuous decentralization of the financial institutional system.

From the beginning, the increasing restriction of demand for investments supported the transformation of the centralized and monopolistic banking system from two directions. The radical curbing of investments sharply pointed out that the prevailing financial institutional system is absolutely unable to cope with a number of problems. Such problems are, for instance: the foundation of an enterprise; the financing of small ventures; the promotion of innovations, inventions, and new technologies; the financing of leasing as well as of developments of the export-oriented domestic background industries (packaging, transportation); and the discount of commercial claims. Under the pressure of restriction, it was more and more obvious that the centrally operated instruments of the intended global cutback—which were not able to affect the already decided or started investments as well as the inefficient production—could not resolve the above-listed problems. New instruments and new institutions would also be needed.

This recognition was also supported by several studies on the distortion of the enterprise organizational system published in various journals at that time. The deterioration in international competitiveness stemming from the rigid structure, the inability of enterprises to adjust, the weakness of innovative inclination, the slow—if any—responsiveness of the economy to external market signals could only be reversed if, among others things, the financial system and its institutional background adjusted to the new requirements, as well.

Like the establishment of any new organization, that of the financial institutions, too, needed capital investment. Peculiarly, in a period of decelerating growth and investment activity due to the restriction, it was restriction itself that generated the necessary resources. The foundation of financial institutions, as a matter of fact, became one of the instruments for withdrawing a money supply which continuously exceeded both the plan and the possibilities. The most characteristic example for that is 'Interinvest', which acquired the majority of its resources from foreign trading companies' development funds that, being abundant, would otherwise have been frozen or taxed away. But it can be observed in cases of other newly established financial funds that they also obtained a part of the necessary resources from technical development, reserve, or cooperative joint-support and development funds which would otherwise have been blocked or openly taxed away. [4] The small financial funds (institutions) could relatively easily be fitted into the financial institutional system, and did not need any essential change in macroeconomic management either (in fact they preserved it in the short run).

The relatively smooth incorporation into the financial institutional system does not mean that, at the same time, the legal status of these funds was defined in an orderly way. They operated within different legal frameworks, in just as many forms as there were funds. They had only one common feature: in a strict sense, none of them had a legal status strictly consistent with the acts on banking and finances. The relatively smooth incorporation into the financial institutional system was due to the fact that their establishment hardly encountered any resistence. The large banks themselves were participants in, or originators of, several new establishments, as well. With that, they partly believed that they had stolen the thunder of those who wanted real changes, and partly perceived themselves how extreme the flatness of banking services was. But the important point certainly is that these small institutions were dwarfed beside them in respect of the volume of activity, the scope of business, and the circle of clients. And last but not least: most of them would not have been viable without founders which, however, continued to ensure the monopolistic position of large banks.

The newly established institutions can be grouped into four main types:

1. *Primary contracting deposit companies,** which have specific physical objectives. This group consists of associations organized by the State Development Bank (SDB) with its equity capital minority. They are independent legal entities and function as engineering associations, thus by no means can they be regarded as financial institutions.

* In Hungarian: Fővállalkozói Betéti Társaság (FÖBT)

2. *Deposit comparies for development,** a type to which only 'Interinvest' belongs. Its activity concentrates on two main areas: first, the organization of ventures; second, leasing and lending for building convertible export capacities. It is a special financial institution with features often a reminiscent of a foreign trading company.

3. *Innovation agencies,* whose objective is financing innovations and establishing ventures for this purpose. They are not only lending but also enterprise agencies. They perform specialized financial activity and they can obtain resources only from the founders (which set a limit to the expansion of their activity). They are strictly profit-oriented.

4. *Small banks,* whose share capital stems partly from sources taxed away or frozen (primarily from the centralized enterprise technical-development funds).** At first they are dominated by strong sectoral (supervisory) constraints, but their main profiles are the so-called 'bank's capital provision', leasing, collection of special deposits, and limited lending. Their scope in respect of passive banking operations is very narrow.

Recently a few *trading houses* were established. These, however, although they take part in the allocation of commercial capital, cannot be regarded as financial institutions. (The developments in the share capital of small financial institutions are shown in *Table 1.*)

Introducing the new institutions did not require fundamental changes in the macroeconomic management system. The small financial institutions were not able to spectacularly transform the financial institutional system and the mechanism of capital allocation primarily because of their size and limited licences. In any case, the fact itself that these forms came into being reflected some change as compared to the situation before. As usual, attempts at easing the apparent tensions were made by creating new organizational forms instead of introducing fundamental changes in the mechanism. These modest steps were designed to substitute for the radical reform of the capital allocation system and the attached financial institutional and organizational system. What actually happened was that, instead of elaborating the conditions for a market selection based on competition of economic units, under the circumstances of a general restriction some tiny valves were opened. It was through these openings that those who were formally good and successful in innovation and convertible export (and partly the small organizations) were given access to marginal resources in order to eliminate or bridge bottlenecks.

This conclusion is also supported by the fact that in late summer of 1979 a governmental committee was set up, and this dealt, among other things, with the modernization of the banking system as well. In the course of the committee work no

* In Hungarian: Fejlesztési Betéti Társaság

** With often used Hungarian abbreviation MÜFA

Table 1

Share capital and profit of the new financial institutions, 1985

	Share capital*	Of which: subscribed in 1984	Expected profit in 1985
		in million Ft	
AGRIT Agricultural Innovation Bank[1]	600.0	357.5	44.8
Innovation Bank for Construction Industry[2]	744.0	720.0	43.9
INTERINVEST Development Credit Corporation for the Development of Foreign Trade[1]	1999.9	1999.9	202.4
Investbank Bank for Technical Development[1]	620.0	620.0	41.7
Development Bank of Industrial Cooperatives[1]	300.0	240.0**	23.5
TECHNOVA Industrial Innovation Fund***[1]	520.0	120.0	8.7
General Bank for Venture Financing[2]	2200.5	1946.0	242.0
Innofinance General Financial Institution for Innovation	500.0	500.0	20.0

[1] Deposit company.

[2] Joint stock company.

* For institutions other than joint stock companies, the term 'initial assets' is used instead of share capital. Subscribed and paid up capital also exist only in joint stock companies—however, in practice others have them as well.

** Ft 300 million as from January 1, 1986.

*** From 1986, this institution is to function as a deposit association under the name of TECHNOVA Industrial Development Bank. Its share capital (initial assets) will be Ft 159 million, while its subscribed capital Ft 424 million.

uniform conception was formed as regards the direction of changes. A common feature of the studies perpared by the NBH* and the Research Institute of Finances [2] was that both wanted to move toward the so-called semi-two-tier banking system.

Formally, the "semi-two-tier" banking system means the separation of central banking and commercial banking functions within one institution. The link between the two departments is established by simulated central banking regulation. Besides that, in a strictly determined scope of activity and circle of clients, small financial institutions can also function, and these are controlled by the central bank with almost purely administrative instruments. The conception of the "semi-two-tier" banking system emerged not merely because of cautiousness or attempts at a political compromise. When the proposal was made, no decision was in effect on the reform of

* The NBH's standpoint at that time is approximately reflected by Ernő Huszti [7].

the economy's organizational and institutional system. In this situation experts did not deem it justifiable to advance too far ahead in the development of the banking system.

"The problems can largely be traced back to the fact that in the present system of macroeconomic control and management monetary policy instruments are partly lacking, and partly do not have those economic effects which could otherwise be expected of them. Therefore, it is true that the prevailing banking system is consistent with the macroeconomic control and management as a whole—not with the intentions, but with the practice of hidden directive planning."[11]

"Historical experiences prove that those efforts which want to strengthen profit-orientation through credit policy alone—i.e. leaving other elements of the macro-economic control and management unchanged—remain unsuccessful. Consequently, there is no sense in a conception which intends to give way to the continuation of the reform process by 'overdeveloping' the banking system. We assume that by the mid-1980s the emergency measures will be eased..., and there will be attempts to extend the enterpreneurial mechanisms to large enterprises as well. The banking system, too, will have to be adjusted to the expected transformation of the enterprise sector." [op. cit.]

Although in the given situation it was generally agreed that the introduction of the "semi-two-tier" banking system was necessary, hot debates emerged among experts because of those who believed that this step would also be the end of the transformation process. According to these experts, the adequate institutional form of indirect management—where credit is a regulatory instrument—is the "semi-two-tier" banking system. They emphasized that credit policy should not follow the central guidelines in details. That is why they underlined that it is necessary to strengthen the autonomy of the central bank against planning and the state budget. This requires that:

— for the implementation of government (economic policy) preferences, it is not the banks generally financing the enterprise sector, but separate specialized financial institutions which should be responsible;

— within the NBH the central banking and commercial banking departments should be separated so that the central bank should be charged with those tasks—the control of money supply, the refinancing of commercial banking departments, interest rate policy, and exchange rate policy—which can be considered as parts of governmental guidance and determinants of monetary and foreign exchange policies;

— financing a deficit exceeding that adopted (planned) by the parliament should only be permitted by parliamentary approval. (Parliamentary approval should also be required for issues of new treasury bills.) [1]

At the same time, preserving the bank's organizational framework as well as avoiding competition were considered necessary because credit-granting is not simply a business activity, but an instrument for implementing economic policy preferences in an indirect way instead of a direct one. The other opinion, however, interpreted the "semi-two-tier" banking system merely as a necessary phase of transition on the way toward a genuine two-tier system. [op. cit.]

In the summer of 1982, in the middle of the debt crisis, attention was once again drawn to the capital allocation system. Such new institutions, instruments and, if necessary, organizations were sought, which could be employed immediately and could produce positive results quickly. A key idea in the proposals was that loss-making and/or indebted enterprises should efficiently be drawn in into the scope of capital flows. Of course, this requires an active capital (stock) market, the widespread use of securities, a profit-oriented and competitive banking system that is able to realize its right of pledge, and institutions that are able to finance restructuring. Achieving these objectives, however, really required a substantial reform.

Among the proposals, eventually, only one came true. This was the introduction of bonds. Again, the probable reason for this is that the bond appears to be the most harmless instrument and seemingly embodies the most negligible change. [10] Another important factor is the recognition that the bond may be a useful instrument for covering the deficit of the state budget as well as for controlling (curbing) the so-called investment purchasing power. This idea was further strengthened by the fact that Hungary became a member of the IMF in 1982, and since then it has not been indifferent to whether the budget deficit is financed directly and exclusively by central bank credit or by other means. The introduction of new financial institutions for promoting the restructuring or liquidation of loss-making production, the application of the right of pledge, the gradual introduction of stock-type securities, the radical reduction of cost-financing supports and their partial conversion for development supports were all adopted as potential instruments for resolving the problem. As a matter of fact, however, only the bond was introduced. One of the reasons was that the inter-firm trade of bonds was expected to be insignificant. At the same time, the bond seemed to be a suitable form for a more civilized deficit-financing and, concomitantly, for freeing and eliminating the frozen funds. Initially, the purchase of bonds by the population was to be confined only to public utility bonds, and it can be regarded as incidental that the population is allowed to purchase general bonds, too. This is also evidenced by the 100 percent state guarantee. In making this decision a lot of policy-makers thought that if the population is allowed to purchase bonds with favourable conditions, it will do so partly out of its cash-savings. Thus, according to this argument, these resources can be rechannelled into economic circulation so that additional resources are generated. The absurdity of this assumption is obvious, yet surprisingly many believed and are still believing in it, thus bringing further support to the application of bonds. Today the bond market has nevertheless only a marginal role, which is also suggested by *Table 2*.

In spite of its insignificant role played in capital flows, the introduction of the

Table 2

*A survey on bonds in circulation in 1985**

Issuers	Potential purchases					
	private individuals		enterprises, cooperatives		total	
	kinds of bonds	Ft mill.	kinds of bonds	Ft mill.	kinds of bonds	Ft mill.
Local and regional councils	15	161	—	—	15	161
Enterprises and cooperatives	40	1702	18	185	58	1887
Banks and financial institutions	—	—	7	1343	7	1343
Total	55	1863	25	1528	80	3391

* Some not really bond-type securities (e.g. the compulsory bond purchases out of enterprise reserve funds in 1984) are not included.

Source: Zsigmond *Járai:* Securities in Hungary. Manuscript, 1985.

bond should be viewed as an important change. It is a new form of horizontal capital flow with a much higher mobility than that of the inter-firm development fund transfers. Due to its negotiability, the bond also reflects to some extent the worth of the issuer enterprise as evaluated by the (capital) market. Initiated by the SDB, an embryonic form of the security market was established. There has been some competition for bond issues among the banks—motivated, for the time being, rather by prestige than by real business interests. A new development is that the SDB takes over the papers to be distributed at its own risk, which may considerably step up the popularity of enterprise bonds.

Following the survival of the liquidity crisis, at the turn of 1982–1983, the further development of the macroeconomic control and management system became really indispensable. It became clear that, without the comprehensive development of the institutional system of a capital market and without the dominance of monetary control in demand management, it is impossible to create consistency between highly restrictive demand management and rapid restructuring as well as adjustment to world market processes of the economy.

The Central Committee of the Hungarian Socialist Workers' Party set up a Consultative Body, whose responsibility was the comprehensive elaboration of the further development of the reform. As a part of the Consultative Body, a team was formed to deal with the *further development of the banking system*. The detailed discussion of the team's history would go beyond the possibilities of this paper. The key problem of the debates, apparently, was whether the creation of an efficient capital allocation mechanism and, in general, of adequate conditions for competition required the decentralization of the banking system—or whether it was sufficient to deal with the improvement of the prevailing institutional—organizational system.

After hot debates, and influenced by shifts in the power relations of the concerned institutions too, the final decision was to decentralize the banking system and establish a two-tier banking system. This sort of two-tier system, however, is not exempt from several problematic features. These, coupled with the fact that the economic environment has remained unchanged, will certainly influence the functioning of the whole banking system.*

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ПРЕДЫСТОРИЯ ПЕРЕСТРОЙКИ ВЕНГЕРСКОЙ БАНКОВСКОЙ СИСТЕМЫ

Л. АНТАЛ—Д. ШУРАНИ

Общеизвестно, что реформа 1968 г. касалась цен, регулирования и стимулирования (что одновременно означало и постановку на задний план плановых заданий) и лишь во вторую очередь занималась перестройкой организационной системы. Этим обьясняется, почему децентрализация предприятий, имеющих монопольное положение, даже не ставилась на повестку дня. Однако это обьяснение не подходит в случае системы финансовых организаций. Ведь реформа изменяла, причем коренным образом, именно функцию и роль этой сферы. Поэтому не случайно вопрос о банковской реформе (в том числе и развитии рынка капитала) встал уже в 1968 г. Также не случайно, что дискуссия о банковской реформе ограничилась лишь теорией, а на уровне принятия решений этот вопрос не ставился даже как возможная альтернатива. Банковская реформа и одновременно с этим и постепенное создание рынка капитала потребовала бы коренного изменения экономической политики.

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THE CONDITIONS OF THE DEVELOPMENT OF BUSINESSLIKE BEHAVIOUR IN A TWO-TIER BANKING SYSTEM

(An *"ex ante"* evaluation of the Hungarian banking reform)

L. BOKROS

From 1st January 1987 the Hungarian banking system has been transformed. Five new, generally authorized commercial banks started operation. Nevertheless, there exist considerable obstacles to creating competition in the banking sector that would force to a veritable business behaviour. A definite sector of clients was assigned to every new bank and this has disadvantageous consequences by reducing the equality of chances and by preserving monopolistic features. The differences in the structure of liabilities might lead to differences in profitability, independent of the activities of the banks. That type of central bank regulation which, in the field of refinancing policy and practice retains the previous, direct credit distribution system, can also become a serious setback in forming the business character of the new banks.

At the heights of the last wave of the Hungarian reform process the government resolution of May, 1984 pointed out that "the businesslike character of crediting must be strengthened" and, more generally, "considerable effort should be made to increase efficiency in overall capital allocation". From another aspect, the letter and spirit of the resolution also supports the conclusion that the central intention of that time was to create a banking system which carries out its main functions according to the logic of the market and as an organic part of it. The development of a market economy presupposes the prevalence of both competition and entrepreneurship which, in turn, have numerous additional conditions closely connected with the basic characteristics of the whole economic and social system.

The aim of this short study is first to overview those fundamentally important requirements which constitute the very necessary, although not sufficient, conditions for the development of businesslike banking in Hungary. Furthermore comparing the structural features of the new Hungarian banking system at the initial stage to the previously mentioned requirements, I shall try to assess to what extent the present institutional setting facilitates businesslike banking, and ultimately chances for competition and entrepreneurial behaviour, in the whole banking system. It should be stressed that we can get to know only the *degree of capability* but not the real dimensions of competition and entrepreneurship. An *"ex ante"* analysis can only reveal the *possibilities in principle* because the conditions determining the real dimensions of businesslike behaviour in the future performance of the banking system are obviously more numerous than those only logically presumable and theoretically necessary.

The first and only formal condition for the development of businesslike banking is the *existence of more than one credit bank,* such financial institutions which are not supposed to make "upper level monetary decisions".* This negative clarification already demonstrates that businesslike banking needs such an organisational framework where monetary decisions based on a logic different from that of the market must be made by institutions clearly separated from credit banks.

The formal meaning of a two-tier system

Monetary decisions belong to the most important macro-level economic decisions in a modern economy. The institution number one responsible for monetary policy and practice is the *central bank* which is authorized for the monopoly of *issuing money* and *regulating money circulation.* In a two-tier banking system the central bank does not have any direct credit, deposit and accounting contacts with the business sector or with the households. These traditional credit banking functions are carried out by financial institutions separated from the central bank.

The existence of credit banks separated from the central bank is always an indispensable characteristic feature of a competitive banking system. However, the transformation of a one-level banking system into a two-tier one does not necessarily bring about any substantial change if we only ensure the prevalence of these formal requirements. Every attempt which tried to make progress merely by grouping the issue bank departments and the credit bank departments into *separate bureaucratic organizations* has necessarily remained unfruitful from the viewpoint of the development of efficient capital allocation [2].

General authorization of credit banks

If the entrepreneurial competition among credit banks is indispensable for the development of businesslike banking then, in order to discover the institutional nature of a two-tier system, we have to learn the conditions for this entrepreneurial competition.

Analyzing the formal requirements of any kind of competition it is necessary

* According to the definition given by Miklós *Riesz upper level decisions* are considered to be those related to not only one economic actor but a certain circle of them. [1]

that the possible scope of *clients and financial services* offered by the different credit banks should *overlap* each other. In this sense we can speak about a competitive situation only if a certain client can look for the *same service at several banks;* i.e. the possibility of choice among banks is objectively given for the clients. The bigger the common slice of client and service scopes of the financial institutions, the greater—*ceteris paribus*—the possibility of choice and hence, the theoretical possibility of competition among banks.

The clientèle and services of the various banks are generally determined by those institutions which give permission for operation—central bank, ministry of finance, independent banking supervision body, chamber of banks, etc. The general tendency is toward *universal banking,* the administrative barriers preventing inroads into the spheres of activity of the different types of banks are step by step coming down [3]. In this respect the new Hungarian regulation opted for a modern solution when the five big banks operating as commercial banks from January 1, 1987 were authorized to offer the almost complete scope of possible services and at least in principle to almost all kinds of possible clients. There have essentially only remained two important restrictions: on the one hand,the foreign exchange operations, which presuppose direct links with foreign partners established by own will, still remain concentrated at the central bank; on the other hand the financial operations with households will invariably be carried out by the National Syvings Bank and the savings cooperatives.

The administrative rules opening up the possibility of choice among banks also include the permission *given to clients for free choice and for establishing parallel contacts* with several banks at the same time. Obviously, the diversification of business contacts with financial institutions is a necessary outcome of the same regulation because the authorization given to banks which results in overlapping of client and service scopes does not make any sense whatsoever if clients are forbidden to take advantage of this situation. The Hungarian regulation clearly follows the progressive line, in spite of the fact that the enterprises can exercise their rights of free choice only from July 1, 1987. onward.

Less well-known, but no less important for the development of competition and, ultimately, for that of businesslike banking is the other side of the free choice possibility, namely, the *right of the banks to choose among their clients.* From January 1, 1987 the Hungarian banks have to meet only the demand of enterprises for opening a checking account but—apart from exceptional cases—they are not obliged to establish credit or deposit contacts with any kind of their clients.

Limits to equal chances in competition in the initial stage

Controlled specialization

The five newly created big banks—in spite of the fact that their authorization does not involve any sectoral, territorial or other type of specialization—have clearly a *sectoral* character according to their initial range of clients. The Hungarian Credit Bank *(Magyar Hitelbank)* had been assigned clients principally in heavy industry, engineering and the transport sector; the second largest bank, the National Commercial and Credit Bank *(Országos Kereskedelmi és Hitelbank)* in agriculture, food processing and internal trade; the third one, the "Budapest" Bank *("Budapest" Hitel és Fejlesztési Bank)* in infrastructure; the Hungarian Foreign Trade Bank *(Magyar Külkereskedelmi Bank)*—in accordance with its name—in external trade. (The smallest of the "big five", the General Banking and Trust Co. *(Általános Értékforgalmi Bank)* has not received any clients in the initial stage.)

The question arises why this kind of specialization can be considered as a disadvantage from the viewpoint of competition. Despite a much more liberal regulation the same tendency can be observed in the great majority of market economies. Moreover, specialization may clearly be even the outcome of competition itself [4].

This is exactly what makes the difference. Market competition can create natural monopolies, which emerge as leading forces in specific areas *by offering better services* than their competitors. But these natural monopolies can always disappear since competition itself can eliminate their advantages, too.

The specialization of the big Hungarian commercial banks is not the result of an organic development, not the momentary outcome of former market competition but has taken shape by previous distribution of clients in an *administrative bargaining process*. In this sense, the big Hungarian banks are artificial monopolies, the very way of their creation has produced burdensome "guarantees" against their eventual elimination by any future competition.

The birth of these artificial monopolies is explained by two reasons. The external factor was the determination of the initial range of clients within the framework of a purely administrative bargain among the Ministry of Finance, the National Planning Office and the National Bank of Hungary which lacked any economic or financial considerations. This was supplemented by an internal factor, namely, that the first two banks—the Hungarian Credit Bank and the National Commercial and Credit Bank were simply born out of the separation of the formerly existing and sectorally organized commercial banking departments of the National Bank of Hungary into two groups which have retained the same profile. The third bank—the "Budapest" Bank—was formed by a simple regrouping of a great part of the old State

Development Bank, the former Budapest Credit Bank and the Pest County Directorate of the National Bank of Hungary. The internal division of labour among the big commercial banks has still preserved its sectoral character, in the same way as the whole system of credit evaluation, decision making and the routine of managers.

If we try to analyse the great difficulties of establishing a two-tier banking system impartially, this outcome seems to be almost natural and, for the time being, unchangeable. It is necessary to emphasize, however, that if the right to free choice among banks had been announced in advance, a better initial situation would probably have been formed. Maybe the client ranges taking shape by free choice would show the same strong specialization, but it is not specialization itself that causes the problem. The specialization taking shape as a consequence of the selection of clients could have already shown partly advantages based on merit, and what is even more important: the very establishment of the banks would have depended upon the value judgements of the market.

This is not only to say that a good opportunity has remained unexploited. The bigger problem is that the formation of client structures by administrative bargain has necessarily led to such further consequences which constitute severe limits to the development of businesslike operation even in the long run.

Differences in size, branch office network and liability structure

The *size* of the five commercial banks operating from January 1, 1987 measured by *balance sheet total* is very different. The two biggest banks—the Hungarian Credit Bank and the National Commercial and Credit Bank—still represent roughly equal magnitudes but the third one—the "Budapest" Bank—has a balance sheet total hardly more than one third of that of the biggest bank. The size of the Hungarian Foreign Trade Bank and the General Banking and Trust Co. is less than half of this one third. These magnitudes reflect such a disproportional setting which could have only been avoided by separating not "two and a half" but at least five generally licensed commercial banks from the former commercial banking departments of the National Bank of Hungary. From the viewpoint of competition it would be much more desirable to have only middle-size banks with roughly equal balance sheet totals in the initial stage.

The size and territorial distribution of *branch office networks* show an even more unequal starting position. The second biggest bank has exactly twice as many branch offices (46) as the first one. The number of branch offices of the "Budapest" Bank is 18, while the fourth and fifth bank have not got any branch offices at all. (In the meantime the Hungarian Foreign Trade Bank established two branch offices, but these offices are newly created ones.) It is even more important that from the 19 county capital cities there are only nine where at least two banks have branch offices. In all the other communities where one can find any banking facility there is only one branch office. Taking into consideration the marked backwardness of transportation and telecommunication of the country and that of the computerization of the banks, the indicated distribution of branch offices considerably diminish the actual possibilities of free choice among banks and that of establishing parallel contacts with them.

The third consequence of the administrative distribution of clients are the *differences in the liability structures* of the newly created banks. In a really modern two-tier banking system it is competition itself which forces the banks to support the growth of their assets with increased deposit taking and, hence, there is a clear tendency toward equalizing the credit-deposit ratios of the different banks. (The prevalence of this tendency can be further promoted by monetary regulation if it determines the maximum refinancing quotas in proportion to the total outstanding credit placements, etc.) But, as a consequence of an administrative assignment of clients, more or less equal credit-deposit ratios can only be established by chance or in the case if the ratio equalisation itself becomes a number one priority in the distribution process. This latter has been the case when the circle of clients of the two biggest banks, was determined, so the proportion of deposits among their liabilities is 25–30 percent, while the share of refinancing is 65–70 percent. But in the case of the third bank deposits cover almost two thirds of credits, and the fourth and fifth banks are in this respect in an even more advantageous position because they hardly have any refinancing needs.

The question arises why these disproportions make the chances in competition unequal. This is so because, in normal cases, central bank refinancing tends to be more expensive than clients' deposits and, hence, the initial differences in liability structures may cause sharp *differences in the level of profitability quite independent of the effectiveness* of the banks' activity.

Operational limits to the development of businesslike banking

Monetary regulation

In a two-tier banking system the capability of deposit money banks to create money is theoretically unlimited. This is explained by the fact that the growth of deposit money has no technical limits and that, in normal circumstances, the great majority of clients do not need central bank money at the same time. Therefore, in order to check the inflationary pressures emerging from the money side, the central bank has to limit artificially the growth of deposit money created by the commercial banks.

It is important that the central bank can only *influence* the money supply but cannot determine it. What the central bank can determine is the growth of central bank money. The central bank can regulate the overall liquidity of the banking sector and the capability of deposit money banks to create money by determining the monetary base. The real size of money stock is determined by the interaction of overall money creation and the demand for money of the non-financial sectors.

Another important feature of monetary regulation is that it only intends to influence the *global growth* of money supply but not directly the capacity of individual banks to create money. A really monetary regulation is *general and normative* in the sense that it transmits the same requirements to every bank. The concrete measures and degrees can obviously differ and change but at a given moment they influence the banks uniformly.

The instruments of monetary regulation are basically of two different types: strategic and tactical ones. The strategic rules have stable degrees and put a ceiling on the growth of overall money stock. The tactical instruments are necessary for daily fine tuning, so their degrees can be changed rapidly and in a very flexible way. The basic requirement for their application is that their *change should be calculable;* this is indispensable for the rational behaviour of banks. Since the growth of the overall money stock is determined not only by the central bank, the calculability of changes in regulation and, hence, the calculability of behaviour of the deposit money banks are also essential conditions for an effective monetary regulation.

One of the most important instruments of monetary regulation is the *refinancing policy and practice* of the central bank. In market economies which have a well-developed banking system and a flexible capital market refinancing is generally a tactical weapon. In Hungary this is the most important and clearly *strategic* instrument of monetary regulation. This is mostly due to the fact that the transition to a two-tier system has taken place under the conditions of considerable external debts and by maintaining the monopoly of the National Bank of Hungary in foreign exchange dealings. In such circumstances the huge foreign debt has remained concentrated at the central bank and, hence, the excess internal liquidity financed by foreign borrowing can only be covered by a huge amount of central bank refinancing. At the moment of establishing a two-tier system, central bank credit must necessarily have a *very large proportion* among the liabilities of the newly created commercial banks. Moreover, the great majority of refinancing is not covered by any security as collateral which points to the backwardness of security dealings (and that of the capital market in general) and even much more to the fact that the excess liquidity of the internal economy has been created by *economic policy initiative.* The huge amount of these refinancing credits will remain a permanent element of the new two-tier system as an undesirable heritage of the past. Since the new commercial banks have not played any role in creating this situation it would be quite unjustifiable to make them suffer its consequences. For this reason, the biggest part of this refinancing credit stock should be distributed among the banks as an *automatically disposable* source of funds. Of course, in the long run these quotas could be reduced in a normative and preannounced way to the extent as bank-initiated and businesslike (market oriented) refinancing pushes out the redistribution of funds based on the central plan. The most important thing is to distinguish between the two types of refinancing in order to avoid the situation where credit distribution directly based on plan decisions of the central authorities prevails under the cover of a seemingly modern monetary regulation.

Unfortunately, the Hungarian monetary regulation introduced on January 1, 1987 does not move in the right direction, thus it is to be feared that the regulation itself will become an even more serious obstacle to the development of businesslike banking than the previously analysed limits of competition. Nevertheless, it seems to be a favourable starting point that the central bank determines the upper limit of short-term refinancing made available for one bank as a fixed multiple of its base capital. If the liability structure of the big banks were at least similar and this multiplied sum remained firmly the same for all of them, then the regulation of refinancing quotas still would remain neutral for competition and, on its part, would leave enough room for the development of autonomy indispensable for businesslike behaviour in credit placing decisions of the individual banks. The differences in liability structures are only impairing the equality of chances in competition but the concrete rules of refinancing are already putting the very possibility of any competition in jeopardy. The internal instructions attached to the enacting clause of the so-called Credit Policy Guidelines issued by the Hungarian government state quite clearly that the banks can have an automatic access to long-term refinancing only in the case of "priority credits" and placements connected with the World Bank programs. In any other case—when they provide medium- and long-term loans autonomously, based only on their own profit considerations without the interference of any centrally determined priority of structural policy—refinancing can only take place by *individual application* and on the basis of *individual contracts* between the central bank and the commercial bank concerned. This means that in all these latter cases a *double credit evaluation* will take place because the central bank limits refinancing not only in quantity but it will enforce qualitative (sectoral, territorial, physical, etc.) "priorities" as well. These measures will considerably limit the autonomy of the new commercial banks and could effectively hamper the development of businesslike banking. Moreover, it will unnecessarily increase the operating costs of the whole banking system.

All these factors constitute the external limits to the development of entrepreneurial competition among banks. An overview of some of the internal factors of businesslike behaviour is, however, also needed.

State owned joint stock company and income regulation

It is a real progress that all the big banks have taken up the form of a *joint-stock company*. The joint stock company represents limited responsibility for the share holders which is very important for an enterprise whose turnover far exceeds its base capital.

It is an objective feature of the transition period that the state has an *absolute majority* in all but one bank. It does not constitute any legal problem since the overwhelming majority of the principially autonomous enterprises are also owned by the state. But state ownership slipped into the modern form of a joint stock company does also contain some dangers. A share represents far more concrete and direct powers for disposition than the much more indirect and structurally divided state ownership. A share gives right to take part directly in the determination of the business policy of the company and also in that of the utilisation of total net profit. In these circumstances and in the absence of an important private and foreign banking community the development of businesslike behaviour would also need the *legally guaranteed limitation of possible state intervention.*

The income regulation of banks which was effective until the end of last year was a simple taking away of all "excess" funds rather than a regulatory system. The centralization of all net income resulted in a motivation completely adverse to that of a market economy; it stimulated the banks to maximize their *costs* instead of profits.

Introducing a tax system is clearly a right step in the right direction. But in the absence of a legal maximum for taxing away net profit under the title of dividends only a halfway progress has been made. As in many other cases, what constitutes a problem is not the degree of income centralization but the very fact that, *in principle, it is unlimited.* Thus the total amount of financial burdens remains incalculable, the banks do not have clearly secured funds. The incalculability of regulatory changes and the unlimited nature of state intervention hamper rational management, reliable planning and effective investment decisions in every productive sector. There is a good reason to assume the same in the case of the new commercial banks as well.

The real sense of the two-tier organisation in a businesslike banking system

The mentioned obstacles indicate and result that the autonomy and profit orientation of the new commercial banks *do not reach the critical level* which would objectively and necessarily lead to the hegemony of the logic of a market economy in their operation. The continuing existence of administrative dependence and management has two reasons: *banking activity has remained subordinated to central planning which continues to stand aloof from maintaining financial macro-equilibrium* *and the financial authorities do not dispose of those regulatory instruments which could assure the prevalence of financial equilibrium* without hampering seriously the autonomy and profit orientation of the commercial banks. The lack of adequate monetary instruments refers to the lack of monetary policy; which in turn shows that the *central bank is still strongly subordinated to the other administrative bodies of macroeconomic management* [5]. Monetary policy in Hungary hardly plays any role in formulating economic policy. The arguments and interests of those institutions which are politically motivated and oriented or have very strong sectoral and territorial background have much more weight in the decisions of governmental committees than the general requirements of preserving financial equilibrium.

The critical level of autonomy and profit orientation of the new banks can only develop if *state intervention is strictly restricted* to the following areas: firstly to a banking supervision which concentrates its activities on protecting the interests of clients and on constantly improving competition; secondly to enforce a normative, stable and legally guaranteed tax system; and thirdly to a really monetary type central bank regulation. Monetary regulation needs an *autonomous monetary policy* which, in turn, would require a complete reshuffle of the existing division of labour within the macroeconomic control and management system. The first step of this change should be an *unambiguous separation of duties and responsibilities among planning, fiscal policy and practice, sectoral and territorial administration and monetary authority;* and its essence should be the *equal ranking of institutions* responsible for these four areas of macroeconomic control and management. We can expect that the central bank becomes capable of formulating monetary policy and influencing effectively global money creation only in a macroeconomic control and management system based on the "equilibrium of counterweights". This capability, in turn, is an indispensable condition that the central bank be able to assume primary responsibility for the stabilisation of the relative external value and internal purchasing power of the currency. In such circumstances the central bank would also be able to give up the direct and non-monetary type regulation of the activities of commercial bank. But the primary responsibility of the central bank for monetary processes and equilibrium can only prevail if the central bank has such a big weight within the system of macroeconomic management institutions that it can-not only influence economic policy, but also *restrict* it, should economic policy eventually contradict the most important goals of monetary policy and ultimately the actual requirements of macro-financial equilibrium.

From the viewpoint of the further development of the Hungarian banking reform it is worth to resume the real content of a two-tier system. According to the above mentioned conditions, for the development of businesslike banking it is necessary not only to separate administratively issue banking functions from commercial banking functions but that central banking functions should become an *autonomous monetary management ranking equally with the other areas of macroeconomic management.* Moreover, commercial banking functions should become *profit-oriented entrepreneurial activities, subject to business venture.* The separation of the two groups of functions is desirable not for multiplying the number of administrative fund redistributing offices but because in a market economy it is a need of primary importance to *distinguish unambiguously macroeconomic control and management from business activity,* and the border between the two—due to the very nature of banking and monetary management—lies *within* the banking system. A two-tier organisation makes this borderline explicit. The real substance of the matter is that this line should be drawn not because of the nature of banking activity but because of the *institutional structure of the market economy.*

If the ultimate goal of the Hungarian reform process is not to develop an economy primarily based on and integrated by the market, then the formal establishment of a two-tier banking system is not only unnecessary but also harmful because it results in a more expensive and less effective central planning management. But if we wish that banking—and what gives sense to it—every kind of enterprise activity should gain businesslike character and became profit oriented, then it seems to be obvious that the formal establishment of a two-tier banking system is far from being sufficient.

The first stage of the Hungarian banking reform has brought about not only formal changes but in certain aspects real progress as well. We must stress for example the establishment of a relatively large number of so-called "specialised financial institutions" which compete with each other in the field of venture capital financing, leasing, factoring, etc. In spite of its children's diseases, the incipient bond market also constitutes a right step in the right direction. We can expect some competition at least in interest rates. There is no doubt that the National Bank of Hungary, as the central bank, will lay greater stress on formulating monetary policy and elaborating the instruments of monetary regulation. All these advances are considered to be important but the really substantial steps are still to be taken.

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ПРЕДПОСЫЛКИ ФОРМИРОВАНИЯ КОММЕРЧЕСКОГО ПОВЕДЕНИЯ В БАНКОВСКОЙ СИСТЕМЕ НА ДВУХ УРОВНЯХ

Л. БОКРОШ

С января 1987 г., когда пять вновьобразованных ссудных банков начали свою деятельность, венгерская банковская система стала двухуровневой. Однако несмотря на то, что новые банки имеют свою клиентуру и сферу операций, перед формированием конкуренции, которая вынуждала бы подлинное коммерческое поведение, стоят серьезные препятствия. В самом начале равные шансы новых банков уменьшает то, что разделение клиентов между ними произошло административным путем, в результате чего каждый банк получил выраженный отраслевой характер. Неблагоприятные последствия такой искусственной специализации — как по количеству филиалов, так и по величине банков — состоят в диспропорциях, усиливающих монопольное положение отдельных банков. Разница в структуре ресурсов ведет к таким различиям рентабельности, которые не зависят от деятельности самих банков. Преградой для коммерческого поведения может стать осуществляемое эмиссионным банком регулирование, которое сохраняет в сфере политики и практики финансирования прежнюю практику непосредственного распределения кредитов. Принципиально неограниченная возможность административного изъятия прибыли с помощью формы акционерного общества может значительно подорвать возросшую в результате введения нормативной налоговой системы заинтересованность в прибыли. Однако общий корень всех названных проблем заключается в том, что — несмотря на реальные и кажущиеся шаги вперед — ссудную деятельность банков не удалось отделить от административных решений. Кредитование продолжает быть подчиненным плану, в котором не учитываются аспекты макрофинансового равновесия. Эта подчиненность показывает слабость монетарной политики, отражающей недостаточную самостоятельность эмиссионного банка.

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HUNGARIAN WAGE RELATIONS: AN INTERNATIONAL COMPARISON*

K. FALUS-SZIKRA

In her inaugural address as full member of the Hungarian Academy of Sciences, the author gives a manysided analysis, showing that the wage scale in Hungary is much narrower than in most capitalist countries. Within that, the wage differentials among manual workers are greater, but those between manual and white collar workers essentially smaller. This is a common characteristic of the wage structure in socialist countries. The wage differentials among white collar workers are also smaller than in the developed capitalist countries. Also the relative earnings of executives are low. Particularly university graduates working in the budget-financed sphere are paid low salaries, first of all the pedagogues. This too, is not merely a Hungarian phenomenon.

The author points out that the distortion of the wage structure is a consequence of the devaluation process of qualification and knowledge going on for years, and it is to be traced back partly to economic and partly to ideological and political reasons. In the latter, also a mechanical interpretation of the Marxian image of society and economy had a role.

We have no exact and objective measure by which to judge the genuine relevance of wage relations. The contribution of individual workers or groups of workers to the values produced is, with very few exceptions, not measurable. Therefore, their wages are not commensurable with those values. It is primarily the practical consequences (i.e. good or bad experiences) that can provide orientation. In addition to domestic experience, it may be useful to get acquainted with international data.

It is general knowledge that it is extremely difficult to draw an international comparison of wage *levels*. The comparison of *wage relations* (relative wages) within a country seems to be a lot more simple. (For example, that of the relative wages of engineers and workers.) However, even this seems to be fraught with an infinite number of difficulties: the lack of sufficient data, the differences between countries in the nomenclatures of qualifications, occupations, and scopes of activity, and in the contents of each category; also taxes imposed on the wages diverge widely; as a rule, there is no way to distinguish between wages and earnings, i.e. between the basic rate and the wage increased by various supplements and floating items—premiums, rewards, bounties, etc. Therefore, we are not in a position to draw a systematic comparison between the countries, item by item. All we can do is try to outline

* Éva *Szeben* and Gizella *Tóth-Sikora* gave me valuable help in collecting the material.

tendencies and characteristic differences; the figures we shall give only show that much and nothing more.

Wage relations have innumerable dimensions. Of these, I shall only discuss the wage differentials on account of qualification, the difficulty of manual work, position in the management hierarchy, and age. My investigations cover only wages and earnings in primary employment, i.e. in the main line of activities. All extra incomes and earnings are left out of consideration. This is not just a necessity because of lack of statistical data, but it seems to be correct in principle, too. The social status and prestige of an occupation are expressed, namely, by the wages paid for it, without any other supplementary incomes. How much an engineer earns by taxi-driving after hours, or by any other activity is not to be taken into account in the prestige of the engineer's work.

The prevailing situation

In Hungary, the wage-scale is on the whole much narrower than in most capitalist countries. The ratio of the two extreme deciles of wage-earners, i.e. of the average earnings of the 10 percent with the highest average earnings to those of the 10 percent with the lowest amounted to 3.6* in the early 1980s, and, minus the progressive contribution to the pension-fund, it amounted to 3.2. Whereas in the advanced and medium-developed capitalist countries the differentation of net (after-tax) earnings is about 4.5—there, too, considering the same deciles—which is much higher. Of course, the differences between individual capitalist and individual socialist countries are also very large in this field. In the medium-developed capitalist countries wage differentials are higher than in the advanced ones. Among the European socialist countries, Hungary is somewhere about the middle in this respect, though it is rather difficult to state its exact position, because of the insufficiency of available data.

The relative wages of manual workers

Yet wage differentials are not in every respect lower in Hungary than in the capitalist countries. In the sphere of the manual workers, these differences are not lower, but higher.

In the (extracting and manufacturing) industry and building industry of seven West European countries (Austria, Belgium, France, Holland, the FRG, Italy, Spain) the wages of semi-skilled workers surpassed those of unskilled workers by 10–15

* to 3.75 in 1985.

Dispersion of the manual workers' earnings in the industry of six countries [1]

Country	Variation coefficient	Gini coefficient	Earnings of the upper decile as a percentage of the lower decile
Belgium (1978)	0.25		
Denmark (1978)	0.21		
France (1978)	0.27	0.15	2.11
FRG (1978)	0.27	0.15	2.26
Hungary (1980)	0.35	0.19	2.62
Poland (1980)	0.40	0.22	3.10

percent, and the wages of skilled workers surpassed the latter by 20–40 percent in the 1970s. Whereas in Hungary, semi-skilled workers earned around 15–20 percent more than unskilled workers, and skilled workers earned almost 50 percent more [2], [3]. Even within the categories of manual workers, differences in earnings are relatively higher in Hungary. Empirical examinations revealed two- and even threefold differences within the same factory: between workers of identical occupation and identical qualification; [4], [5] such a thing is inconceivable in the West. The main reason for such large differences between manual workers* lies in the labour shortage. The evidence for this is, on the one hand, shown in the fact that labour plays a key role in easing bottlenecks, and yet, because it is scarcely available, it must be considerably overpaid in comparison with its performance; and on the other, because, similarly on account of the labour shortage, the Hungarian enterprises cannot dispense even with labour of the poorest performance. That is why performances are much more widely dispersed in Hungary than they are in the advanced industrial countries. Finally, it must be taken into account that in Hungary a larger share of the workers receive a *task wage* (piece-rate or other) than in the West.

Relative wages between manual and non-manual (white-collar) workers

While income differentials among manual workers are much higher in Hungary than they are in the Western countries, between manual workers and intellectuals they are much lower. This is the case not only in Hungary, but it is a common characteristic of the socialist countries. In the mid-1970s the Österreichisches Institut für Wirtschaftsforschung (WIFO) made [6] a comparison between the data of six socialist countries (Bulgaria, Czechoslovakia, Poland, Hungary, Romania and the Soviet

* These differences do not derive from the basic wage tariff, but much rather from the various wage supplements, floating items, etc.

Union), and of Austria. This revealed that in Austria the average net earnings of non-manual workers (technical and clerical staff) exceeded those of the manual workers by 60 percent, while in the six socialist countries this difference was only about 20 percent. A recent French investigation compared the data of Belgium, Denmark, France, and the FRG with those of Hungary, Poland, and the GDR, for the year 1980. This investigation revealed that in the capitalist countries in question the earnings of the non-manual workers were on average 30–70 percent higher than those of the manual workers; in the socialist countries the former exceeded the latter by no more than 5–13 percent.

The relative earnings of manual and non-manual workers in seven countries

Belgium (1978)	1.49
Denmark (1978)	1.30
France (1978)	1.70
GFR (1978)	1.38
Hungary (1980)	1.13
Poland (1980)	1.05
GDR (1980)	1.05

Source: [1] p. 8.

Finally, a large part of the highly qualified intellectuals, such as physicians, engineers, lawyers, economists, etc. are self-employed in the capitalist countries. Also, though dispersion is wide, the earnings of the self-employed are generally high above those of white-collar employees of the same profession.

Relative salaries of intellectual (white-collar) workers

It seems that in Hungary as well as in other socialist countries, differences between earnings among the intellectual workers are also lower than they are in the West. Here, differences are lower between the salaries of intellectuals with different degrees of qualification, as well as between renumerations paid for intellectual routine work and those paid for creative and innovative activities.

The earnings of office-clerks without any special qualification remain below those of skilled workers in a number of capitalist countries.* However, highly qualified

* Of course, the situation varies in each country. In Britain and the FRG, for example, the wage categories of manual and non-manual workers largely overlap, so that some of the skilled or semi-skilled workers earn more than subordinate office-clerks. Such overlap, however, does not occur in France or Italy [7]. In the latter two countries, office-clerks earn more than skilled workers; the enterprises' wages structure covers, instead of two overlapping patterns, just one clearly arranged wages hierarchy.

specialists earn much more than specialists with lower degrees of qualification. In France, engineers' earnings were more than double those of technicians in 1979. In the 1970s in the FRG, those with a diploma in engineering (corresponding to Hungarian engineers holding a university degree) earned about 30 percent more, and engineers holding a doctor's degree earned about 60 percent more than graduate engineers (corresponding to Hungarian production engineers who graduated from a college). [8] Also, differences are even greater (depending on scope of the activity, and the kind of duty accomplished) among the subordinates. In the U.S.A., for example, the earnings of engineers engaged in R&D, and of designer engineers in the fast developing industries, amount to double or even treble the average earnings of engineers.

The earnings of Hungarians holding managerial (executive) posts are low by international comparison. In 1983 the monthly income of top-level enterprise managers (managing directors, technical directors, etc.) amounted to 2.4-fold of that of manual workers* and not quite double that of non-manual workers.** In capitalist countries, the wages of top managers are not published, but even without such data, estimates for the year 1980 concerning the manufacturing industry of five European advanced industrial countries showed managers' earnings to be between 3- and 9.9-fold of those of manual workers. In the U.S.A. the salaries of the top managers of giant companies are, according to estimates, about tenfold of the average workers' wages, [9] while fifty-fold differences also occur. Between the consecutive levels of managerial posts—for example, between a head of a section and head of a major department—a two-or threefold difference in earnings is not infrequent.

It is widely known that the salary of young professionals (university graduates) is extremely low in Hungary: it amounts to 80–85 percent of the wages of skilled workers of the same age. Up to 30 years of age, a professional can earn about 60 percent of the amount of income that a skilled worker could earn in his life up to the same age. [10] In France in the mid-1970s the monthly earnings of engineers under 25 years amounted to 186 percent of the earnings of skilled workers in the same age group. [11] In the FRG in 1976, with the average monthly gross wage of workers measured as 100 percent, that of the young graduate engineer amounted to 151 percent, and that of the young engineer with a diploma to 176 percent.*** If however, the earnings of young professionals are not compared with those of manual workers, but with those of senior professionals, the Hungarian situation does not seem so extreme. The earnings of engineers under the age of thirty amount to about half of those of engineers above fifty. Such or similar wages proportions are not infrequent in the advanced industrial countries, either. In the U.S.A., an engineer at the peak of his career earns about 80 percent more than at the

* 2.63-fold in 1985.
** Data obtained from ÁBMH Labour Information Centre.
*** Computed on the basis of data from: *WDI Nachrichte*, 38. 1977.

beginning. In the FRG in 1973 every tenth engineer received 360 percent of his initial salary at the age of 57, and even the worst paid engineers of the said age earned 50 percent more than their initial salary. [8].

In the final account, what the international comparison has revealed is that the extremely low earnings of young professionals in Hungary is not simply a problem of the young generation, or that of starting on a career, but it is part of the entire range of complex questions regarding the valuation of intellectual work in general which is made especially bad for young people by the unsolved problem of housing.

Wages (salaries) in the non-profit sphere

As is well known, an increasing part—in the most advanced countries the overwhelming majority—of workers are employed in the non-profit sphere.* The non-profit branches: health, education, culture, administration, etc. are the traditional domains of intellectual work. The data of the 1980 census show that in Hungary 57 percent of intellectuals were engaged in these domains. While in the profit organizations the participation rate of intellectual workers amounted to 22.3 percent, in the non-profit organizations it was 62.8 percent. At the same time, the wage-level of the non-profit organizations amounted to only 97.8 percent of that of industry in 1984. Professionals employed in the non-profit sphere of the national economy earn much less than those working for profit-making organizations. This is not a special characteristic of Hungary, and not even one of the socialist countries. In the capitalist countries, too, the situation is the same in quite a number of the non-profit organizations, i.e. in the publicly financed sector. Engineers, lawyers, and economists working in the civil service earn considerably less than their colleagues employed in industry or trade. In France, executives of the top and middle ranks earn, on average, 67–83 percent of what cadres of the same qualifications earn in the private sector. [12] This difference is, however, compensated by the higher security of jobs held in the publicly financed sector: protection against dismissal, and by other advantages, such as higher pensions, higher family allowances, etc. In Hungary, no such compensation exists. Lower earnings are at the most compensated by better working conditions in a few cases. At the same time, wage differentials are high even within the publicly financed sphere. In the central administrative organs, earnings are considerably higher than in other fields of the publicly financed sector, and even higher than in industry. While in the health service, social welfare, and cultural fields the average wage amounted to 96 percent of the economy-wide average in 1980, in communal, public administration and other services it amounted to 119.4 percent. [13] Teachers, in

* I.e. in all institutions financed from the (central or local) state budget.—Ed. note.

particular, are badly paid in Hungary, so, too, are those engaged in cultural services, such as librarians, servants of popular culture, etc.

ILO (International Labour Organization) made, in the late 1970s, the so far widest survey of teachers' payments in the five continents of the world. [14] It shows clearly that the relative wages of teachers in Hungary, as well as in other socialist countries, are considerably lower than they are in other countries of the world.

In the developing countries, the relative earnings of teachers are very high, as is usual with intellectuals in these countries. The maximum average earnings of secondary school teachers not infrequently surpass, by as much as 4–5-times, the average wages in the manufacturing industry. In the advanced industrial countries the rate is much lower. At the time of the data collection (the mid-1970s), young primary school teachers earned less than the average wages of the manufacturing industry (including the wages of intellectual workers—also those of professionals—employed in the industry), while this very rarely occurred in the case of young secondary school teachers. One of those rare cases was Italy, where the commencing salary of primary school teachers amounted to 58.2 percent of the average wages in the manufacturing industry, and that of the young secondary school teachers amounted to 76.2 percent. Among the advanced industrial countries, teachers' relative earnings are especially high in Belgium, Holland, and Switzerland. In Switzerland, primary school teachers' commencing salary amounted to 127.5 percent of the average wages in the manufacturing industry, and that of young secondary school teachers to 213.7 percent. Secondary school teachers in the highest income bracket could earn there more than treble the average wages of the manufacturing industry (307.3 percent). In Holland, primary school teachers' commencing salary equalled 102 percent of the average wages paid in industry, that of young secondary school teachers equalled 160.7 percent, and the highest teachers' salary reached 286.4 percent of the average wages paid in the manufacturing industry. In respect of the U.S.A., the survey does not show commencing salaries, but the aggregate average wages of primary school and secondary school teachers; these amounted to 131.5 percent of the average wages in the manufacturing industry. [14, pp. 94–95.]

It seems that among the socialist countries the relative earnings of teachers are highest in the GDR. At the time of the survey, young primary school teachers received 81.1 percent, and young secondary school teachers 89.3 percent of the average wages in the manufacturing industry. In the Soviet Union, the aggregate average salaries of primary and secondary school teachers amounted to 79 percent of the average wages in the manufacturing industry [14, pp. 94–95.]. For Hungary, too, only aggregate data concerning primary and secondary school teachers are available. The average salary of primary and secondary school teachers was Ft 5.571 on December 31, 1985, while the average wage in industry was Ft 5.945 which is to say that the teachers' average salary amounted to 93.7 percent of the average wage paid in industry, and the commencing salary of teachers (having worked for less than 3 years) to 67 percent.

The said study of the International Labour Organization summed up the most important symptoms in connexion with the insufficient payment of teachers. They are the following:

— Insufficient replacement. To fill the necessary staff number, individuals not having the required qualifications must be employed.

— The high number of teachers leaving the profession.

— Quite a number of teachers undertake, in order to complete their income, some regular activity independent of their main task.

In order to avoid misunderstandings: this is not talking about Hungary. This is the summary of data collected in many countries.

It seems that in the sphere of salaries paid for research work, Hungary's position in the international scene is even worse. A recent Polish survey has revealed that, from six European socialist countries, it is in Hungary that the relative salary of the research worker is the lowest on an economy-wide average.*

The situation as outlined above is the outcome of a process of devaluation that has been going on for years.

The process of devaluation

The differences between wages paid for the work of high and of low qualified personnel show a decreasing tendency, historically and on a world scale. Such differences are higher in the developing countries, and lower in the advanced states. This is mainly due to the higher educational standards of the advanced countries: there is less scarcity of qualified labour. The process of lessening of wage differentials by

* *Average salary of workers in the scientific sphere as a percentage of the economy-wide average*
(Economy-wide average wage: 100)

Country	Year				
	1970	1980	1981	1982	1983
Bulgaria	111	108	111	111	111
Czechoslovakia	116	113	114	114	114
Poland	122	107	100	88.8	93.6
Roumania	110	108	110	108	107
Hungary		95.8	95.7		
Soviet Union	105	106	106	112	107

Source: Gospodarka planowa, 7–8. 1985. p. 424.

qualification is, however, much faster in Hungary and in the other socialist countries, than it is in the capitalist states. In the capitalist states it is from time to time stopped by a strong opposite tendency: the faster growth of the wages of highly qualified labour. This is what happened, for example, in the FRG and in Great Britain in the 1970s. In France, these opposite trends have been so strong since World War II that only the wages of office-clerks have decreased in comparison with those of manual workers, but not the salaries of highly qualified professionals and of managers. [12]

However, the difference in the speed of the process is not the only one. In the advanced industrial countries, wage differentials by qualification have been most conspicuously lessening among manual workers, that is, between qualified and less qualified workers, since World War II. This has been the result of increased special requirements and training for unskilled and semi-skilled workers as a consequence of mechanization and automation. Among intellectual workers, wage differentials have even been increasing in a few advanced industrial countries: the wage position of the most highly qualified professions has improved.

As opposed to this, in Hungary as well as in other socialist countries, wage differentials between manual workers and highly qualified intellectual workers have been decreasing since World War II. In six European socialist countries, the wages of engineers and technicians exceeded those of manual workers on average by about 50 percent during the 1950s. By the mid-1970s, however, this difference had sunk to 20–30 percent [15] and has been sinking since.

Prior to World War II, in 1938, skilled workers in Hungary earned one and a half times as much as unskilled workers, and engineers and technicians earned twice as much as skilled workers. [16] In the fifty years that have passed, the differences between wages of skilled workers and semi- and unskilled workers have not decreased significantly. In 1982 still, the wages of skilled workers amounted to 145.1 percent, and those of semi-skilled workers to 118.2 percent of those of unskilled workers. [17] The relative wage position of highly qualified professionals has, however, much worsened.

After the monetary stabilization i.e. the introduction of the forint in 1946, the wage ratio between manual and intellectual workers fell from 3 : 1 (of 1938) to 1.5 : 1. Between 1949 and 1956 further levelling took place at a fast rate, while the nominal wages of industrial workers grew by 92 percent, and those of the technical staff (engineers and technicians) by only 52 percent. The wage adjustment of 1957 brought a new wave of levelling. As opposed to the average 20.4 percent rise of wages of industrial workers, the earnings of the technical staff rose by only 11.8 percent. It was only ten years later, at the time of introduction of the new economic control and management system, that the trend changed—and then only for a short period. Yet, by 1969, there was already conflict about the distribution of profit shares. Parallel with the halting of the economic management reform, started in 1972, the levelling tendency was again predominant. In 1972 a decree was issued by the Council of Ministers to the effect that the wages of non-manual workers could only be raised to the extent of the wage increases of manual workers. Although the decree was concerned only with that one year, in practice it affected the whole decade. Right up to the late 1970s it was considered a mistake, in several industries, if the average earnings of the intellectual workers of an enterprise were higher, or were increasing faster than those of manual workers. This was a setback even in obtaining the title "Eminent Enterprise".* Thus the situation came about, singular in an international comparison, that during the 1970s not only were the percentual differences between the average wages of subordinate (non-manager) engineers and manual workers decreasing in Hungary, but the absolute differences were decreasing as well.** The wage position of those holding executive posts was also worsening. The average earnings of top enterprise executives were 3.1-fold of those of full-time workers in 1969, but only 2.3-fold in 1980 [20].

In the mid-1980s, sure signs of changes are showing. The wage position, i.e. relative wages of enterprise managers and executives, directly controlling production, have improved. The converging tendency of engineers' and workers' wages, that had been going on for decades, stopped in 1983. In a few enterprises the position of the highly qualified professionals has been improved above the average. The change is, however, a small one.

The devaluation process affected (even more severely) those employed in the non-profit or, more exactly, in the publicly financed sector. In Hungary, their earnings were always rising less than those of the workers of the profit-making sectors, and were following the latter with a delay and at a lower level of increase. The lag is still increasing. While the real wages in the profit-making sector rose by 28.5 percent between 1970 and 1985, those in the non-profit sector increased by only 18.6 percent. A tendency which has been prevailing for several decades is that while the rise in enterprise wages (earnings) nominally surpassed the estimates in almost all the five-year plan periods, in the publicly financed sector "plan discipline" and "strictness" were asserted with a lot more consistency. In the latter, usually, only the originally planned nominal rise in wages was carried through, even if prices were growing faster than envisaged. [21] No change has taken place in this field, even in recent times. Between 1981 and 1985 the nominal wages of enterprise workers grew by 37 percent, those of the employees of the publicly financed sector by 28 percent. Those working for the publicly financed sector bear a much larger share of the burden imposed by the country's difficult economic situation.

István *Benke* has recently examined the changes in real wages of teachers and research workers of the Budapest Technical University between 1970 and 1983. [22]

* A title awarded for enterprise performance, according to various criteria, by the Council of Ministers.

** Between 1971 and 1980, it had fallen from Ft 1.362 to 975. Computation based on: [18, 19] and the 1980 representative survey of the Ministry of Labour.

The result: on a national average, the real wages per worker (i.e. employee) *grew* by 18 percent during the thirteen years under examination, whereas those of the teachers and research workers of the University *fell* by 10 percent. We carried this computation further, partly relying on estimated data. We have found that, while real wages remained unchanged on a national average between 1983 and 1985, those of the teachers and researchers of the University decreased by a further 6 percent. The balance of the fifteen years between 1970 and 1985 is the following: 18 percent increase in real wages on the national average; 16.6 percent decrease at the Budapest Technical University.

Gizella Sikora-Tóth made similar computations at the Heavy Industrial Technical University of Miskolc on the basis of data of 1980–1985. Her computations demonstrated that the real wages of the teachers and researchers of the University decreased by 13.2 percent during those five years. It may not be without interest, either, to learn that the real wages of administrative employees of the University (having no academic qualifications) decreased only to the extent of the national average, or even less during the same period.

The difference in the rate of increase in wages in the publicly financed sector and in the enterprise sphere, i.e. the lagging behind of the former, is also a recurring problem in the capitalist countries. Several attempts have been made to mitigate the difference. For example, by indexation of the wages paid in the publicly financed sphere according to the consumer price level; or, in a few cases, according to the rise in wages in the enterprise sphere.

The detrimental effects of the low payment of highly qualified activities (selection of the unfittest, lowering of requirements and performances, etc.) are well known. Therefore, I do not discuss them, but wish to investigate the causes instead.

The causes

What are the main causes of the low remuneration, and bad devaluation of highly qualified personnel and their activities in Hungary? They are partly economic, and partly political-ideological.

Economic causes

Among economic causes, the most important one is extensive growth, i.e. low propensity for innovation, or the lack of the pressure for innovation.

Extensive growth has led to a bad shortage of labour, and in it especially of labour of low qualification, doing hard physical work. (It is a general international experience that, if anywhere labour shortage is serious, the problem is always worst in the field of hard physical work. Namely, if it is possible to make a choice, this is the kind of work people will not choose.) As a consequence, the bargaining position of labour of low qualification and undertaking hard manual work greatly improved in Hungary: their wages were growing the fastest. In the advanced industrial countries the shortage of workers doing hard physical labour or work of low social prestige has been eased in the last decades by increased mechanization and the employment of guest workers, (which has pressed down their wages). In Hungary, however, neither mechanization to replace hard physical work, nor the employment of guest workers have been important.

On the other side, demand for highly qualified labour is low in Hungary, again because of extensive growth, and because of the lack of the pressure for innovation. This mainly concerns the technical profession, but other fields of creative work are involved as well. There is no labour shortage in these activities, or at least to no such extent as in labour of low qualification. The enterprises are not forced to constantly renew their products and technologies, in the way capitalist firms are. Also, in recent years, when this necessity has begun to be more conspicuous, the financial resources for innovation have been short. The highly qualified professionals are rarely given tasks that demand the most of their abilities.

Further, it is not without interest, from the aspect of the demand for highly qualified labour, and of the utilization of their abilities that (according to a survey made a few years ago), almost half of the enterprise medium- and top-level executives have no higher qualifications (university degree or equivalent). [23] These circumstances, together with quantitative overtraining in a few fields, resulted in a deterioration of the wage position of highly qualified labour, and their work has become devalued.

In the pressing together of hierarchical wage differentials and in the unfavourable wage position of lower-level managers, a role is also played by the hierarchy having too many managerial levels. [24] It is an international experience that wherever the number of hierarchical levels is too great, wage differentials between the consecutive levels will shrink. (In Hungary, even in a medium enterprise 6–7 managerial levels are found between the workers and the managing director.)

In the capitalist countries wage differentials by qualifications are connected with the cyclical movement of the economy. At times of slump and high unemployment, such wage differences grow. Namely, enterprises first dismiss labour of low qualification, which is not indispensable, and easily replaceable. Supply of such labour is high, while the demand for it shrinks or ceases—therefore, its wage position deteriorates. Qualified labour: skilled workers and highly qualified professionals are less struck by unemployment. (That is how specialists of the question explain that for example in the FRG, France, Great Britain and Italy, the shrinking of wage differentials stopped in the mid-1970s and opposite tendencies emerged.) [25] During a boom, the situation is the opposite: wage diferentials by qualification decrease, and levelling tendencies get stronger.

In Hungary and in the other socialist countries, even though economic development is similarly cyclical, the labour market functions as if the economy were in a constant state of boom—which is a consequence of the shortage phenomena and of the forced extensive growth.

In the capitalist countries, economic crisis and emergence from it represent a period of restructuring and technical renewal of production. At such a time, demand grows for highly qualified professionals holding a key position in the process and, therefore, their wage position improves considerably. This is what happened in the years following the crises of the 1970s. In the advanced industrial countries demand suddenly grew for engineering professionals inventing and perfecting new technologies, and for ingenious young managers. In France, for example, between the years 1977 and 1987, while the offer of jobs directly attached to production fell back to a half, demand for specialists of computer techniques grew 2.5-fold, for researchers it grew to 2-fold, and parallel to it, the wages of these categories were rising fast. In the somewhat exaggerated formulation of the trade press: French enterprises are willing to pay just "any" price for the cadres indispensable to them. [26] In the U.S.A., for seven of the ten professions mostly in demand, academic qualifications are needed. At the same time, the income of the highly qualified young professionals has considerably grown in comparison with that of labour of medium-degree qualifications. A similar process took place in the FRG between 1980 and 1985. While among manual workers wage differentials decreased, those between the lowest and the highest categories of non-manuals grew from 105 the 122 percent. [27] It seems, in the final account, that the improvement of the wage position of highly qualified labour carrying out original and creative intellectual activities is part of the emergence from crisis in these countries.

In Hungary, the economic crisis is less sharp and more prolonged in time than it is in the capitalist countries. Neverheless, it affects the labour market. Unemployment has been avoided so far, but a transformation of labour demand, necessary for structural and technical renewal, has not come about. In the course of an investigation of 1983, the answers indicated shortages mainly of unskilled and semi-skilled workers and—in the sphere of non-manual workers—of typists. [28] This does not seem to be the labour demand of technical renewal. The increased demand for, and utilization of, high-level intellectual creative activity, and its adequate remuneration must be the condition of emergence from crisis in Hungary, too.

At present, the *decrease or stagnation of the real wage* is often indicated as the obstacle to a more distinct wage differentiation, and within it, of wage differentiation according to qualification. It is a widely acknowledged view that when the real wage level is decreasing or stagnating, there is no way to enhance wage differences. This opinion is, however, not supported either by international or Hungarian experience. As has been mentioned, in the capitalist countries wage differentiation by qualification is enhanced at times of emergence from crises, and yet these are, as a rule, the periods when real wages decrease. However, in Hungary, while during the period of a relatively fast real wage growth (lasting from the early 1960s to the mid-1970s) wage differentials between workers of low and those of high qualifications sharply decreased, in recent years, in spite of the declining real wages, this tendency seems to have stopped in industry, as has been mentioned. The changes in wage differentials are not dependent on the rising or falling tendency of the wage level—they must not be made dependent on it: if only because the raising of certain wage differentials may become, under the given circumstances, the condition of economic progress and thereby also of the general rise of real wages in the future.

The political-ideological causes

In the changes of wage proportions, ideological-political factors always play a role in addition to economic ones. They account mainly for the differences in the relative wages of the socialist and the capitalist countries. They are the main factors lying behind the devaluation of the highly qualified intellectual activities. I cannot undertake to examine these causes in all detail—all I want is to raise a few thoughts.

The system of the personality cult distrusted the intelligentsia, fearing its criticism, and its "thinking along other lines". It tried to win over only a small group of leading intellectuals, by means of favours and privileges. However, the end of the system of the personality cult brought no improvement in the financial remuneration of intellectual activities. After 1957, the levelling tendency did not stop at all, but intensified. The most obvious reason for this was the weakness of the enterprise forces representing proprietory interests in countering the levelling tendency. Enterprise managers cannot hold out against the levelling pressure which is also supported by social organizations. (That is why such cases may occur as that of a large Hungarian enterprise in the provinces: not long ago, the managers of the said enterprise decided to raise, by an average 20 percent, the salaries of the highly qualified professionals, since they recognized the extreme importance of technical development. However, by the time their suggestion had made the usual way through the forums of social organizations, trade union organs and party committees, no more than a monthly Ft 200 remained.)

Also in the West, trade unions exert pressure towards reducing wage differentials. There are, however, very strong counter-forces acting against the levelling efforts. Enterprise managers grant many different favours to the highly qualified specialists that are important for the enterprise, even by surpassing the wage tariffs fixed in the collective agreement. (While in Hungary wage tariffs are often transgressed in the case of manual workers, in the capitalist countries the case is the opposite: wage tariffs are transgressed for the sake of highly qualified professionals.)

Power relations within enterprises, however, do not provide satisfactory explanation. It is not without reason these power relations are what they are, for they develop under the effect of social and political, and within them, ideological factors. Of the ideological ones, the most important one seems to be, for our examination, the rigid and mechanical interpretation of the Marxian conception of society and economy—seemingly ignorant of the changes that have taken place in the meantime.

The Marxian conception of economy has two actors: the capitalist and the worker. The intellectual has a subordinate role only. The intellectual helps the capitalist in organizing the working process and, at the same time, exploitation. Within this conception, it is only manual work that is productive, or, it is only the directly productive work that produces value. In Marx's time, when he wrote *Capital,* this was in fact the situation. During the hundred and more years that have passed since, however, the world has changed considerably. The key phases of the production process (organization, development, and control functions) have become independent and are now the special tasks of highly qualified intellectuals. At the same time, the highly qualified intellectual has also become the key figure or the (non-material) service sector constituting the greater part of the economy in the most advanced countries. From an insignificant group, the intelligentsia has grown to be a large mass, the fastest increasing group of the working population. Theory has not kept pace with those changes. The largely increased role of the intelligentsia has not been noted in ideology, and has not received due appreciation. The view is still alive and active, in which only a tertiary role is assigned to the intelligentsia, behind the basic classes of society: workers and peasants. This plays an important role in the poor representation of interests of the intelligentsia and thereby in the devaluation of highly qualified intellectual work.

When levelling efforts are given way at the different forums of decision-making, this amounts in effect to preferring short-term political interests to the real, long-term economic and political interests of the large masses. Of course, only as much as is available can be distributed. However, how much is available and, what is more important, how much will be available, depends, beside other things, on wage policy and relative wage.

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ПРОПОРЦИИ ЗАРАБОТНОЙ ПЛАТЫ В ЗЕРКАЛЕ МЕЖДУНАРОДНЫХ СРАВНЕНИЙ

К. ФАЛУШ-СИКРА

Автор многосторонне анализирует то обстоятельство, что в Венгрии шкала заработной платы гораздо уже, чем в большинстве капиталистических стран. Однако внутри этого различия в заработной плате между рабочими, занятыми физическим трудом, больше, а между рабочими и работниками умственного труда — существенно меньше. Это является общей особенностью структуры заработной платы в социалистических странах. Среду работников умственного труда различия в заработках также меньше, чем в развитых капиталистических странах. Относительная заработная плата руководителей также низка. Особенно плохо оплачивается труд дипломированных специалистов, занятых в бюджетной сфере, в первую очередь — педагогов. Это также не только венгерская особенность.

Автор указывает, что искажение структуры заработной платы является следствием процесса обесценивания знаний, который идет уже много десятилетий, и частично объясняется экономическими, а частично — идеолого-политическими причинами. В последних роль сыграло и механическое толкование Марксовых представлений об обществе и экономике.

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INTERFIRM WAGE DIFFERENTIALS IN HUNGARY: CAUSES AND CONSEQUENCES

G. KERTESI–E. CUKOR

Relying on a comprehensive database, the study makes an attempt at the explanation of differences in firm-level wages, applying a cross-sectional analysis. The main findings are as follows: 1. The differences in enterprise profitability have no remarkable influence on the differences in enterprise level wages; 2. The differences in question can practically be traced back to two factors: the segmentation of the labour market and the accumulation of bureaucratic advantages and disadvantages stemming from central wage increases as well as from tax reliefs; 3. These bureaucratic effects, interpreted by the authors as a forced wage adjustment to the labour shortage, are surprisingly strong even in the post-reform economic system; 4. Among the common features of the redistribution of enterprise incomes and the forced wage adjustment to the labour shortage, the authors lay primary emphasis on the passive role of the state, specifically, that the state interventions are called forth in both areas by short-term tensions of the economy. According to this interpretation, state intervention is actually a quasi-automatic bureaucratic adjustment reacting to the strongest prevailing pressure.

I. Introduction*

Enterprise wage level is a central category in the Hungarian system of wage regulation which has called forth sharply contradictory standpoints and often induced hot debates for the past 15–20 years. Although the methodology and concrete form of regulation have many times been subject to transformations since 1968, one of its essential features has remained virtually unchanged—i.e., the emphasis laid on the relationship between enterprise wage level and enterprise profitability. According to the macroeconomic control apparatus, the enterprise wage level—consequently, individual wages too—should reflect the profitability differences among various enterprise activities. The consecutive models of regulation were formed in consistency with this principle, and they were different primarily in respect of what variables they wanted to establish a link between: the level or the total of earnings on the one hand, and the level of profitability on the other, or between the growth rates of these variables.

* We are indebted to László *Csontos*, Ödön *Éltető*, Péter *Galasi*, János *Kornai*, János *Köllő*, Ágnes *Matits* and László *Mátyás* for their helpful comments and criticisms.

In the background of the idea in question looms one of the essential problems of the socialist economic system: namely, that under the conditions of state ownership the motive of rational (economical) utilization of resources (including labour) is ineffective in enterprise activity. One of the specific features of socialist enterprises is that they exhibit an almost unsatiable demand for resources (including labour). Their demand is not reduced by an increase in costs because, due to shortages in commodity markets, they have to face negligible resistence if they want to assert the increase in costs in their prices. All this implies that under the conditions of socialism there are no such automatisms at the micro-level which could contain the demand for labour as well as the potential wage outflow of enterprises within the limits of profitable operation. Consequently, instead of economizing on wages as a component of production costs, enterprises are interested in a virtually infinite increase of wage payments.* This is why the institution of central wage regulation is separated from the general regulation of the economy in all centrally planned economies.

Thus, one of the tasks—according to some experts,** the only genuine task—of wage regulation is just to keep back the strong wage-inflationary push emerging at the micro-level of the economy by direct or indirect means. Prior to 1968, in Hungary—similarly to the current practice in most other socialist countries—the possibilities for enterprise wage increases were determined in the course of annual bargaining with the authorities, in a necessarily bureaucratic procedure. Accordingly, as a rule, those enterprises, industries and occupational groups could gain benefits which could refer to stronger nationwide interests, current priorities or responsibility for supply, or could threaten with the danger of significant shortages—in other words, which had stronger *bargaining power*.

In 1968, with the introduction of the new economic mechanism, the justification of the bureaucratic allocation of wage-increasing possibilities was challenged. As it became clear that, in general, bargaining was inadequate for the rational allocation of resources necessary for current production, it was also recognized that the allocation of wage-increasing possibilities through vertical bargaining mechanisms was inconsistent with the spirit of the reform. The development of enterprise wages should thus be controlled by economic automatisms, instead of bureaucratic considerations. In line with the general principles of the reform, it seemed to be obvious that the basis of this *automatism* should be enterprise *profit**** although, from a theoretical point of view, the necessity of a close positive correlation between the level of profit and that of enterprise wages, or between the growth rates of these aggregates, is rather

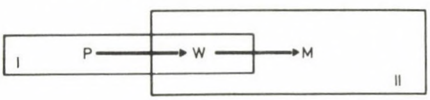
* See I. R. *Gábor's* article (4) and Chapters 11 and 16 in Kornai's book (9).

** For instance: I. R. Gábor–Gy. *Kővári* (5).

*** "It is necessary to create such circumstances in which the development possibility of the enterprise depends on the development of *profit*, whereas the latter exerts a *significant influence on personal incomes of enterprise employees, too*." (1) p. 103—(italics by the authors).

questionable. In the course of further discussion, we will make an attempt to clarify empirically, and not theoretically, the nature of relationship between these twovariables. The (relative) wage position of an enterprise is hereinafter understood as its rank in the hierarchy of enterprises on the basis of its average wage level.

Whatever determines enterprise wage position—profitability or the authorities' intention—its *importance* is primarily attached to the role it plays in the allocation of labour. Since under the conditions of labour shortage the allocation of labour is determined in the first place by its voluntary mobility, wage regulation, through influencing enterprise wage positions, tries to influence mobility processes as well. The substance of the idea is that the differences in wages (W) among enterprises induce mobility (M) processes in a way that the workforce moves toward enterprises offering higher wage level II: (W → M). Accordingly, if wage regulation manages to create a situation in which the differences in enterprise wage (W) positions reflect the differences in profitability (P) I: (P → W), then, indirectly, it also succeeds in stimulating the workforce to flow toward more profitable areas (P → M). Wage regulation thus aims at controlling the outflow of wages, consequently the demand of enterprises for labour as well, in a way to promote at the same time the rational allocation of labour in line with macro-level interests, through operating the mechanism shown in the chart below:



Although our paper is to deal primarily with the *causes,* and not the *consequences,* of differences in the wage level of enterprises, we cannot bypass this mobility assumption without making some comments. This is because if this assumption proves to be false, then it is practically indifferent from the point of view of rational labour allocation what determines the differences in the wage level of enterprises, since in this case mobility processes cannot be influenced by tackling that, and only that, variable. We should therefore try to find those conditions under which we can predict adequate response in mobility, once enterprise-level wage differences are known. Our assumptions partly concern in the wage structure, more precisely, the interfirm and intrafirm dispersion of individual wages, and partly the preferences of employees.

As for the *dispersion of individual wages,* in this context it is sufficient to distinguish between two cases. If the average wage level of two companies is different, then 1. the company with a higher wage level has no such employee (applying a less strict criterion: has relatively very few such employees) who earn(s) less than the better paid employees of the company with a lower wage level; 2. a (considerable) part of employees of the company with a higher wage level earn less than a part of the better paid employees of the company with a lower wage level. The difference between the two cases can also be interpreted by formal criteria: 1. in this case, the dispersion of individual wages can fully (or almost fully) be traced back to the dispersion of average enterprise wages ($\sigma_b^2/\sigma^2 \approx 1$)*; 2. the dispersion of average enterprise wages only partly explains—if at all—the dispersion of individual wages ($\sigma_b^2/\sigma^2 < 1$). The *extreme* of case 2 is the situation when inter-firm wage differences do not represent the differences in individual wages at all ($\sigma_b^2/\sigma^2 \approx 0$).

Regarding the *preferences of employees*, distinction between two extreme types is sufficient as well: *a)* in one of the cases, the mobility of workers is exclusively determined by the size of their individual wages (wage maximization); *b)* in the other case, in addition to the size of current and potential individual wages, the mobility is also influenced by the disutility required for achieving higher wages (maximization of relative net advantage).**

Table 1 represents combined cases of different types of wage dispersion and preferences of employees, as discussed above. On the basis of the table, it is obvious that, once the differences in enterprise wages are known, we can have—in line with (II)—unambiguous predictions concerning mobility if and only if (la) is the case. That is, if, on the one hand, there is no (applying a less strict criterion: there is only a minimal) overlap among internal wage intervals of different enterprises and, on the other hand, there is no other factor besides potential wages influencing the motivation of employees in the choice and change of employer. If (1b) or (2a) or, particularly, (2b) is the case, the above described predictions concerning the direction of mobility become absolutely uncertain. This is because the larger the overlap among internal wage intervals of enterprises is, the less possible it is to exclude that a worker of a company with a higher average wage level can find such a job at a company with a

Table 1
Preferences of employees and types of wage dispersion

Types of wage dispersion		Preferences of employees: Wage maximization (a)	Preferences of employees: Maximization of relative net advantage (b)
$\sigma_b^2/\sigma^2 \approx 1$	(1)	1a	1b
$\sigma_b^2/\sigma^2 < 1$	(2)	2a	2b

* Where σ^2 measures the dispersion of individual wages around the mean of the sample (total variance), whereas σ_b^2 the dispersion of the average wage level of companies around the mean of the sample (between-group variance).

** See *Rottenberg* (12).

lower average wage level which offers a better individual wage than what he received in his former job. (Even in the theoretically rather improbable case, if we assume wage maximization (2a) on part of the workers.) On the other hand, if the preferences of employees are also influenced by the different degrees of disutility implied by alternative employment possibilities beside their individual earnings, then (even in the case of definitely separated internal wage intervals (1b)) it may occur that workers flow toward areas with lower average wage level, if they find that in these areas the marginal disutility of wages is lower, i.e. they can make a better bargain.

We believe that strong theoretical arguments support the idea that the preferences of employees follow the latter pattern (corresponding to case *b*), while strong empirical arguments also support that the type of intra-firm and inter-firm dispersion of earnings corresponds to case 2, moreover, falls close to its *extreme* value.

We have tried to verify the above statement making use of a database* containing individual data of some 300 thousand manual workers. The results are presented in *Table 2*. This table shows that, relating to the total sample (see the bottom line), inter-firm differences in average wages explain a mere 25–30 percent of the dispersion of individual wages. In other words, the majority of differences in individual wages is of *intra-firm* origin. This suggests that, in respect of enterprise internal wage intervals, the overlap is very significant. An even more significant overlap can be found if industrial differences are eliminated. Moreover, within certain industries—for instance, mining, metallurgy, engineering or construction materials industry—it is found that the difference in enterprise wage position is absolutely irrelevant to the dispersion of individual wages. From the point of view of individual wages the intra-firm situation is virtually the only factor that matters. This, however, shows a fairly wide dispersion with all the employers.

Thus, as regards the *consequences* of enterprise-level differences in earnings for mobility, we have arrived at rather distressing results. Facts do not seem to support the validity of the II: (W → M) mechanism, which itself raises doubts about the assumption that the central wage regulation is capable of promoting the rational allocation of labour. But, what can be told about the validity of the I: (P → W) mechanism or, in more general terms, about the *causes* of differences in enterprise-level wages? As mentioned earlier, the requirements that differences in average wages should reflect those in profitability is rather questionable from a theoretical point of view. Still, since the central wage regulation definitely strives for establishing this link—however obscure it theoretically is—we deem it worthwhile to examine *empirically* whether, in practice, it functions or not. If not, then what determines the differences in enterprise wage positions? *Has the regulatory system, which—although frequently changing—has remained profitability-oriented in official declarations ever*

* The 1980 wage survey of the Ministry of Labour.

Table 2
Dispersion of individual wages
(1980, manual workers)

Industry	Individual wages			$(\sigma_b^2/\sigma^2)*100$ percent	
	mean	standard deviation	variation coefficient (percent	balance sheet	wage survey
	in Ft, rounded to '00s				
	(1)	(2)	(3)=[(2)/(1)]*100	(4)	(5)
Mining	5900	2200	37.2	5.4	7.0
Electric energy industry	4300	1300	28.8	10.4	13.4
Metallurgy	4900	1400	29.0	4.1	5.1
Engineering industry	4100	1300	30.9	7.7	9.2
Construction materials industry	4100	1200	28.6	3.2	3.7
Chemical industry	4400	1300	29.2	10.4	9.3
Wood, paper and printing industries	4000	1200	31.1	16.5	19.0
Textile and other industries	3600	1100	30.7	19.8	13.4
Food industry	4000	1200	29.6	10.6	14.8
Construction industry	4400	1300	28.5	15.4	13.4
Transport and communications	4700	1500	31.2	11.4	11.4
Commerce	3400	1100	30.8	11.2	14.7
Total sample	4100	1400	34.0	30.4	25.4

Note: Owing to the small sample size in the case of relatively small enterprises, for the estimation of (σ_b^2/σ^2) two different methods have been applied. Average earnings of manual workers (4) are data taken from enterprise balance sheet reports prepared for the Ministry of Finance; data in column (5) have been estimated from individual data of the 1980 wage survey of the Ministry of Labour. This procedure has implied some biases in both cases: in the case of (4), the basic equation of the variance analysis does not hold since data on individual wages and those on enterprise average wages stem from different sources. As for (5), in the case of relatively small enterprises the representation is presumably not sufficient. Nevertheless, we believe that – in spite of these biases – the estimations give a good picture on, at least, the approximate size of differences between within-group and between-group variances.

since 1968, succeeded at least in breaking the impact of the earlier periods' bureaucratic control and vertical bargaining mechanisms?

For answering these questions, we will rely on a multivariate regression analysis, using a database to be presented in the following section. However, before starting to review the database, the variables and the applied causal models, we must draw attention to certain *limitations* of our *analysis*. 1. In the formulation of the models, we have left out of consideration the *differences in the techniques of regulation* which have been frequently modified since 1968. The reason for that, however, is not only the pressure of necessity but a conscious consideration, too: we believe that what is important is not the specific forms of regulation but the idea behind them. And this—however obscure—practically reflects two principles: the link between the enterprises' wage level and profitability has to be maintained both in the short run, i.e. statically, and in the longer run, i.e. dynamically. This paper cannot undertake more than to test this idea or, in the case of alternative hypotheses, make only static analyses. 2. All along the discussion, only *cross-sectional* analysis will be applied (the year of reference is 1980). The omission of a dynamic analysis is primarily justified by the difficulties of compiling the necessary time series. This is the most significant deficiency of our reasoning. Nevertheless, we believe that our results are worth being published even at this level because, to our knowledge, the relationships in question have not yet been analyzed under *ceteris paribus* conditions. 3. The analysis is confined to the labour market of *manual workers*. Accordingly, the companies drawn in into the sample are those which dominantly employ manual workers.

The variables have been collected from two databases: (1), (2), (3),* (5) and (6) variable groups have been derived from the database of the Ministry of Finance containing enterprise balance sheet reports for 1980; data for the structure of workforce (4) from the 1980 wage survey of the former Ministry of Labour. Since the latter database contains individual data of workers, these data had to be transformed to firm level, in consistency with *Table 3*. Of course, the sample constructed in this way represents a narrower circle of companies than that of the database of the Ministry of Finance which can be considered ideal for firm-level analyses: it practically covers the macroeconomic sectors of industry, construction industry, transport and communications** and commerce (n = 1665 companies). In this circle of companies, the *(unweighted)* mean of firm-level wages of manual workers was Ft 3480/month in 1980, with a standard deviation of Ft 645 and a variation coefficient of 18.5 percent. It is attempted to explain this dispersion by the following type of regression model:

* We are indebted to Ágnes Matits for her valuable help in the construction of the pre-tax/pre-subsidy profit (PTSPROF) and redistribution (RED) variables.

** The Hungarian State Railways and the Hungarian Post, as practically non-profit institutions, have been omitted from the sector of transport and communications.

Wage = f (company type, profitability,
composition of workforce,
industry, location)

Table 3
Variables of the model

1. Wages	Average enterprise wages of manuals workers (Ft per capita per month)	WAGE
2. Company Size/type	Net value of enterprise fixed assets (capital) (Ft million)	CAP
	Number of manual workers (persons)	EMPL
	Ownership (state enterprise = 1, cooperative = 0)	OWN
3. Profitability	Balance sheet profit (Ft million)	BALPROF
	Pre-tax/pre-subsidy profit (Ft million)	PTSPROF
	Redistribution = balance of state subsidies and taxes (± Ft million)	RED
4. Compositon or work-force	Ratio of each category within the total number of enterprise manual workers, percent	
a) Sex	Ratio of women	WOMEN
b) Age structure	Ratio of workers over the age of 50	OLD
	Average age (years)	AGE
c) Qualification	Ratio of workers having formal qualification	QUAL
	Ratio of highly skilled workers	HISKILL
	Ratio of semi-skilled workers	SESKILL
d) Working conditions	Ratio of those performing hard work	HARDW
	Ratio of shift workers	SHIFT
	Ratio of overtime workers	OVERT
5. Industry		INDUSTRY
6. Location	Location of the company headquarters in (1) Budapest, (2) other town, (3) village	LOCAT

The basic model has been specified in two different ways: in case I, profitability is measured by balance sheet profit (BALPROF), whereas in case II, it is replaced by the variables of pre-tax/pre-subsidy profit (PTSPROF) and redistribution (RED). The linear regressions concerned are presented in *Table 4*. In the course of the further discussion, we will first of all make an attempt at the interpretation of these two regression models; more precisely, we will try to confront the results derived from them with the hypotheses outlined in the previous section of this paper as well as with popular ideas on the subject.

II. Profitability and average enterprise wages: tracing a misconception

Nearly three-quarters of the variance of average enterprise wages are explained by the variance of variables included in the above models; this rates as a very good result in social statistical practice. Let us first consider the effect of the actually realized enterprise profit (BALPROF), that is, our model I.

II. 1. Profit and redistribution

Our data prove that there is no strong relationship between the level of earnings and that of profitability. The direct impact of profitability on the wage level is very weak: a Ft 1 million increase in the volume of balance sheet profit raises enterprise per capita wages—*ceteris paribus*—by even less than one forint (0.2869). The weakness of the relationship becomes even more evident if the dispersion of balance sheet profit is also taken into account (mean = Ft 53 million, standard deviation = Ft 124 million). Under *ceteris paribus* conditions, the volume of profit is likely to vary only within narrow limits. Even if a change of a whole unity was assumed in the standard deviation of profit, this would result in a mere Ft 36 change in the wage level in respective direction, which only amounts to 6 percent of the standard deviation of firm-level wages. (In order to better understand the magnitude of the amounts in question, note that in 1980 the average monthly earnings of manual workers in the state and cooperative industries were Ft 3952. (See [7].) On the basis of those pointed out above, we can formulate the following statement:

STATEMENT I: *The differentiation of enterprises by balance sheet profit—ceteris paribus—only exerts a virtually negligible influence on the differentiation of enterprises by wage level.*

The question may be raised: is it not possible that such a weakness in the impact of profitability on the wage level may be explained by the fact that the indicator of balance sheet profit reflects the real profitability of firms inaccurately? Is the clue so simple that, since "the profitability actually asserting itself breaks away from the original profitability."* because of the massive fiscal redistribution of enterprise incomes, there is no reason to believe that the indicator of balance sheet profit will establish the expected strong positive correlation between profitability and wages? What would be the relationship between profit and wage level without redistribution,

* Kornai—Matits [10] p. 229.

Table 4

Regression models for the explanation of the dispersion of the average enterprise wage level (N = 1665)

Independent variables	Model I			Model II		
	Unstandardized parameter	Standardized parameter	t-value	Unstandardized parameter	Standardized parameter	t-value
		$R^2 = 0.738$			$R^2 = 0.738$	
Intercept	2669			2681		
Company type						
CAP	0.0310**	0.0555	3.1	0.0401*	0.0720	4.0
EMPL	−0.0131**	−0.0353	−1.9	−0.0073	−0.0198	−1.1
OWN	185*	0.1419	8.3	193*	0.1480	8.9
Profitability						
BALPROF	0.2869*	0.0552	3.3	–	–	–
PTSPROF	–	–	–	0.1071	0.0905	1.6
RED	–	–	–	0.1733+	0.1309	2.3
Composition of workforce						
WOMEN	−9.4*	−0.3684	−15.2	−9.6*	−0.3759	−15.7
OLD	−8.8*	−0.0915	−4.6	−8.8*	−0.0922	−4.6
AGE	29.2*	0.1178	5.3	29.6*	0.1195	5.4
QUAL	3.1*	0.0820	4.6	3.1*	0.0809	4.5
HISKILL	4.9*	0.0839	5.2	4.6*	0.0800	4.9
SESKILL	−1.8*	−0.0356	−2.2	−1.8**	−0.0361	−2.2
HARDW	2.4**	0.0538	3.2	2.0**	0.0444	2.7

SHIFT	2.1*	0.0802	4.6	2.0*	0.0771	4.5
OVERT	3.3*	0.0861	5.8	3.2*	0.0847	5.6
Industry						
Mining	1943*	0.2940	20.8	1966*	0.3020	20.8
Electric energy industry	201+	0.0313	2.2	177++	0.0276	1.9
Metallurgy	780*	0.1441	10.4	787*	0.1454	10.4
Engineering industry			Category of reference			
Construction materials industry	81	0.0165	1.2	77	0.0155	1.1
Chemical industry	255*	0.0700	4.7	272*	0.0747	5.0
Wood, paper and printing industries	21	0.0079	0.5	23	0.0084	0.5
Textile and other industries	–55	–0.0330	–1.5	–56	–0.0330	–1.5
Food industry	221*	0.1000	5.3	222*	0.1002	5.2
Construction industry	171*	0.0923	4.5	169*	0.0910	4.4
Transport and communications	256*	0.0622	4.3	222*	0.0539	3.6
Commerce	–156*	–0.1086	–4.3	–144*	–0.1004	–3.9
Location						
Budapest			Category of reference			
Town	–319*	–0.2470	–15.1	–327*	–0.2537	–15.5
Village	–366*	–0.2263	–13.3	–375*	–0.2319	–13.6

*$p \leq 0.001$; **$p \leq 0.01$; $^{+}p \leq 0.05$; $^{++}p \leq 0.10$.

Note: Parameters of the equations in this paper have been estimated by the ordinary least squares (OLS) method. *

or how, and in what direction, is it modified by the government's taxation and subsidization policies? Answering these questions needs the clarification of two interrelated, but ultimately separate, problems: one is the direction and strength of relationship between pre-tax/pre-subsidy profit (PTSPROF) and redistribution (RED); the other is the direction and strength of influence of these variables on enterprise wages (WAGE). In fact, with a knowledge only of the relationship between the variables of PTSPROF and RED, no conclusion can be drawn about the effect exerted by these variables on enterprise wages. Both problems call for solution. Let us first focus on the influence of PTSPROF and RED on firm-level wages (WAGE). This can be analyzed with a model in which balance sheet profit (BALPROF) is replaced by the pre-tax/pre-subsidy profit (PTSPROF) and redistribution (RED) variables. Our model can accordingly be transformed with no difficulty since the latter two variables explain balance sheet profit quite well.*

Model II of *Table 4* proves that—provided all other variables are held constant—pre-tax/pre-subsidy profit (PTSPROF) has an even weaker impact on the wage level than the variable of BALPROF. Each Ft 1 million change in PTSPROF results in not more than some Ft 0.1 change, in the same direction, in firm-level wages (0.1071). Redistribution (RED) appears to be in a somewhat stronger and, similarly to PTSPROF, positive correlation with the wage level although it cannot be considered too strong, either. In our model, the positive sign of the balance of redistribution means net subsidization, while the negative sign net taxation. The positive sign of the regression parameter attached to the variable therefore means that a Ft 1 million increase in subsidies is accompanied by a minimum (as low as Ft 0.1–0.2) rise in the wage level (0.1733).**

As for the relationship between PTSPROF and RED, as explained in more detail below, the magnitude of redistribution (RED) is primarily influenced by pre-tax/pre-subsidy profit (PTSPROF) from among the potential (theoretically applicable) variables (see *Table 6* on page 94). Between the two variables—even after having eliminated the effect of potential control variables—a very strong (almost functional) negative correlation is found. The value of the respective standardized regression parameter is -0.9834.

* The regression equation is as follows:

$$\underset{}{\text{BALPROF}} = 22.6 + \underset{(40.7)}{0.6071}\ \text{RED} + \underset{(47.7)}{0.6346}\ \text{PTSPROF} \quad R^2 = 0.617$$

In parentheses the respective t-values ($p \leq 0.001$)

** The weakness of this relationship becomes even more obvious if also the standard deviation of the concerned variables is taken into account. Even if the standard deviation of PTSPROF (mean = Ft 93 million, standard deviation = Ft 545 million) and RED (mean = Ft -35 million, standard deviation = Ft 372 million) changed by a whole unity, the resulting change in average enterprise wages would only be Ft 60 and Ft 64, respectively, which merely amounts to 9–10 percent of the standard deviation of firm-level wages.

The simultaneous consideration of the two problems in question suggests that pre-tax/pre-subsidy profit (PTSPROF) influences firm-level wages (WAGE) in two different ways: directly and through redistribution (RED).* The relationships among the variables are shown in *Figure 1*.

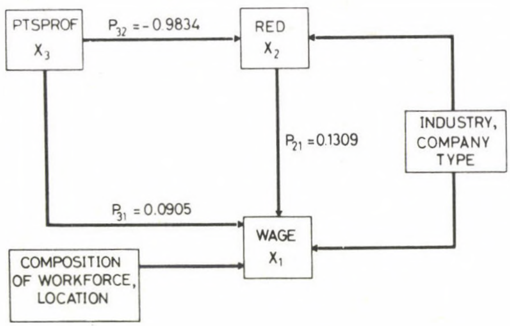


Fig. 1
The direct and indirect effect of pre-tax/pre-subsidy profit on the level of enterprise average wages

The direction and strength of the *direct* effect are indicated, on a comparable basis, by the standardized regression parameter of PTSPROF estimated from Model II ($p_{31} = 0.0905$). As for the direction and strength of the *indirect* effect exerted through redistribution, it is given by the product of the standardized regression parameters of RED (estimated from Model II) and PTSPROF (estimated from the model of *Table 6* [$p_{32} * p_{21} = (-0.9834) * 0.1309 = -0.1287$]. What becomes visible here is actually an economic policy which, as frequently complained of, substantially alters the profit position of companies—i.e. by taxing away from those who are profitable, while subsidizing the loss-makers—resulting in an effect of *opposite* direction compared to the direct effect of the PTSPROF variable on wages. However, the fact that the indirect effect through redistribution of pre-tax/pre-subsidy profit on firm-level wages is of opposite direction to, and stronger than, the direct effect of the concerned variable does not automatically mean that its direct effect (i.e. without that of redistribution) is

* The direct and indirect effects of pre-tax/pre-subsidy profit have been separated by path analysis (see Asher [2]). The parameters in *Figure 1* have been estimated by two equations—the equation of Model II presented in *Table 4* and the one shown in *Table 6*. The path coefficients p_{31}, p_{21} and p_{32} are identical with the standardized regression parameters belonging to the respective variables of the regression equations concerned. For the sake of clarity, the parameters attached to variables that are *not* used in the argumentation of this section have not been indicated in *Figure 1*. Of course, these parameters could be presented with no difficulty on the basis of the two equations mentioned above. Finally, since the applied statistical computer package (SPSS) is unsuited for a simultaneous estimation of parameters of the two equations, a worse-than-optimum method, i.e. the separate estimation of parameters, has been used as a second-best solution. We believe, however, that this circumstance does not affect our conclusions.

in itself significantly strong. On the contrary, this effect is *extremely weak*. Accordingly, the impact of fiscal redistribution and the effect of pre-tax/pre-subsidy profit can be summarized as follows:

STATEMENT II: *The fiscal redistribution of enterprise incomes—the joint effect of taxes and subsidies—actually distorts the profitability relations of enterprises to a very significant extent, while it completely deteriorates the otherwise positive effect of tax-exempt and subsidy-exempt enterprise incomes on firm-level wages. At the same time, neither the direct effects of pre-tax/pre-subsidy profit nor the indirect ones modified through redistribution—are sufficiently strong for exerting a tangible influence on enterprise wages. In other words: enterprise profitability would have no substantial influence on enterprise wages even if fiscal redistribution did not exist at all.*

II. 2. A digression: some reflections on the nature of fiscal redistribution

As we could see in the previous section, the close negative correlation between pre-tax/pre-subsidy profit (PTSPROF) and the balance of taxes and subsidies (RED) can be deduced from our database as well. This can by no means be regarded as a new result.* The study of János Kornai and Ágnes Matits [10] was the first one which pointed out this phenomenon on the basis of a comprehensive empirical database. In addition, their study also drew attention to an important criterion of inter-firm redistribution: the levelling of profits and profitability. At the same time, however, it left an essential question unanswered: is there any tendentious bias in redistribution? Is it possible to identify such a circle of companies which, as a rule, has a bigger chance for state subsidies than others, or is there such a circle which normally is a loser in inter-firm redistribution? What is the *rule* of the interfirm allocation of taxes and subsidies? Based on the theoretical literature on fiscal redistribution, the Kornai–Matits study presents four potential explanations to which it adds its own as the fifth one: the levelling of enterprise incomes *(e)*. The four hypotheses under consideration are as follows: "a firm has more chance to enjoy a preference if *(a)* it is in a 'preferred (priority) sector'; *(b)* it is a big firm; *(c)* it is one of the 45 or 50 big firms specially selected for extra attention by the superior authorities in the early 1970s; *(d)* the firm has good connections with the superior authorities through personal ties."** In our opinion, our data, as well as the multivariate regression technique applied so far allow us to *compare those hypotheses* of fiscal redistribution among the above-listed five

* Unlike the finding that the almost functional negative relationship between the variables of PTSPROF and RED does *not* have any remarkable impact on average enterprise wages (see STATEMENT II above).

** Kornai–Matits [10], pp. 233–234.

Table 5
The explanation of redistribution (RED) by stepwise regression

Order of inclusion	INDUSTRY	COMPANY SIZE	PTSPROF	R^2	Change in R^2
	a	b hypothesis	e	percent	
1	X			6.7	–
2	X	X		7.2	0.5
3	X	X	X	95.1	87.9

which refer to the preference of protected sectors *(a)*, preference of big enterprises *(b)* and endeavours to level out enterprise incomes *(e)*.

In the regression presented in *Table 5*, redistribution (RED) is explained by independent variables necessary for the verification of the hypotheses in question (INDUSTRY, company size = CAP, EMPL and pre-tax/pre-subsidy profit- = PTSPROF). The applied equation is a stepwise regression which draws independent variables into the equation in a predetermined sequence, and not simultaneously. It therefore facilitates to determine the extent to which the various groups of independent variables contribute to the dispersion of the RED variable to be explained.

What is found here is that the industrial differences, whether alone or together with the impact of company size, do not give sufficient explanation of the dispersion of RED containing the balance of taxes and subsidies, since not even their joint explanatory power exceeds 7.2 percent (see *Table 5*). With the inclusion of pre-tax/pre-subsidy profit (PTSPROF), however, the explanatory power of our model increases by leaps and bounds, to 95.1 percent. The decisive influence of PTSPROF is also evidenced by the standardized regression parameters, which can be directly compared since the standardization has eliminated their difference in terms of magnitued stemming from the different units of measurement as well as size of dispersion of the original variables (See *Table 6*). Further on, we will try to interpret the parameters of this regression equation from the point of view of the three hypotheses under consideration.

As for the *firm-level* allocation of taxes and subsidies, the magnitude of redistribution primarily depends on pre-tax/pre-subsidy profit—actually with a negative sign. The linear taxation of enterprises included in our sample amounts to nearly 90 percent. In other words, Ft 880 thousand of each Ft 1 million of the produced primary profit is taxed away and, on the other hand, Ft 880 thousand of each Ft 1 million of the deficit of primary profit is compensated by the state budget. But the effect of company size should not entirely be disregarded, either, and the volume of capital seems to have an exclusive influence here. This means that if a company is big only in terms of its staff but not in terms of capital, then—at least on the basis of its size—its access to state subsidies is fairly unlikely. However, if it disposes of a large stock of capital, then it can certainly expect state subsidies due to its size, even if it employs relatively few workers as compared to the volume of its capital. The effect of capital-proportionate subsidization (*b*-hypothesis) at enterprise level is nevertheless significantly weaker than that of the profit-proportionate taxation (*e*-hypothesis). This is evidenced by the difference between the standardized regression parameters concerned, which is very significant (*b*-hypothesis: 0.1102, *e*-hypothesis: −0.9834).

Table 6

The explanation of redistribution (RED)
(regression parameters), $R^2 = 0.951$

Variables	Unstandardized parameter	Standardized parameter	t-value
Industry			
Mining	−81.5⁺	−0.0163	−2.8
Electric energy industry	−104.6*	−0.0216	−3.6
Metallurgy	125.4*	0.0307	5.2
Engineering industry		Category of reference	
Construction materials industry	−24.0	−0.0064	−1.1
Chemical industry	42.5**	0.0155	3.2
Wood, paper and printing industries	−12.8	0.0062	1.0
Textile and other industries	−7.9	−0.0063	−0.8
Food industry	65.7*	0.0393	5.8
Construction industry	−7.5	−0.0054	−0.7
Transport and communications	184.3*	0.0594	10.0
Commerce	0.0	0.0000	0.0
Company size			
Capital	0.0464*	0.1102	15.3
Employment	−0.0048⁺	−0.0172	−2.4
PTSPROF	−0.8797*	−0.9834	−175.8
Intercept	15.3	–	–

*p ⩽ 0.001, **p ⩽ 0.01, ⁺p ⩽ 0.05.

The appraisal of the effects at *industrial level* is much more difficult because the validity of our conclusions seems to be depreciated by the fact that data are available only for one year, which has made it impossible to analyze that element of the *a*-hypothesis whether the circle of industries preferred or dispreferred by redistribution can be regarded as temporally stable or not. Of course, this does not mean that the hypothesis of industrial differences cannot be interpreted by a cross-sectional analysis.

As a matter of fact, there are substantial differences in the magnitude of subsidies and taxes across the industries (see the first column of *Table 7*). To what extent can these industrial differences be attributed to the effect of profit-proportionate taxation or deficit-proportionate subsidization (*e*-hypothesis); to what extent to the fact that the typical firm size is different (*b*-hypothesis) in different industries; and to what extent to the circumstance that the government's subsidization and taxation policies are based on purely industrial viewpoints (*a*-hypothesis)?*

Table 7

The relative strength of (a), (b) and (e) redistribution patterns at industrial level

Industry	Deviation from national average (Ft million)	RED_p	RED_s	RED_i	$\frac{RED_p}{RED_s}$	$\frac{RED_p}{RED_i}$
		sign				
	(1)	(2)	(3)	(4)	(5)	(6)
Mining	–1170	–	+	–	22.2	12.6
Electric energy industry	–154	–	+	–	1.3	1.6
Metallurgy	–102	–	+	+	5.1	2.3
Chemical industry	–64	–	+	+	3.1	4.1
Engineering industry	–17	–	–	–	2.8	0.8*
Wood, paper and printing industries	14	+	–	–	9.5	1.8
Construction industry	16	+	–	–	4.5	2.8
Food industry	30	–	+	+	18.8	0.5*
Textile and other industries	32	+	–	–	6.5	3.6
Transport and communications	276	+	+	+	1.4	0.3*

Note: The table does not include the sectors where the balance of redistribution is equal, or close, to the national average (construction materials industry, commerce).

The data of *Table 7* reinforce, also at industrial level, the hypothesis of profit-proportionate taxation. It is necessary to make some comments on this table. The data appearing in the table have been produced in such a way that the regression estimation of *Table 6* has been transformed to industrial level by weighting the parameters of the regression equation with the average values of independent variables typical of the respective industries. The company chosen as the basis of comparison is one whose employment, capital stock, primary profit, etc. reflect the national average. The next step, then, has been subtraction of parts of the industrial level regression estimations

* The standardized regression parameters cannot be applied here since, in case of the dummies representing the variable of INDUSTRY, the standard deviation used in the course of the standardization cannot be interpreted.

attributable to the individual variables from the respective figures relating to the reference company. Relying on the reference category as the basis of comparison, it is possible to verify in respect of each sector what part (in Ft millions) of net taxation or net subsidization stems from the fact that the size of the representative company of the given industry differs from that of the total sample (RED_s); what part stems from the fact that the primary profit of the representative company of the given industry differs from that of the total sample (RED_p); and finally, from the fact that—independently of its profit level and average firm size—the given industry is granted subsidies or burdened with taxes to a particular extent (RED_i). Columns 2 to 4 of *Table 7* indicate the signs of these factors: a negative sign means net taxation, whereas a positive sign net subsidization.

Let so focus on the highly important columns 5 and 6 of *Table 7,* which show—without sign—the relative strength of industrial level redistribution effects stemming from differences in profit level and company size ($|RED_p/RED_s|$) on the one hand, and that of the effects due to differences in profit level and industrial status ($|RED_p/RED_i|$) on the other hand. As has been pointed out at the beginning of the previous paragraph, data evidence *predominance of the effect of profit-proportionate taxation/deficit-proportionate subsidization.* Apart from a few exceptions—see the figures with asterisk—this effect is significantly stronger in almost all cases than that of the differences either in company size or in industrial status.

*

Now we will summarize our findings concerning the nature of fiscal re-distribution. With the concept of levelling profits or differences in profitability, we seem to have arrive not merely at one of the features of fiscal redistribution but at its *particularly important aspect,* whose significance—at both firm and industrial levels—goes beyond the hypotheses of "favoured sectors" or "protected big companies". Nevertheless, we should not say that the hypotheses of "favoured sectors" or "protected big companies" are unfounded; biases are experienced at both levels (at industrial level, they have been revealed by us too: see the first column in *Table 7*). At the same time, however; it is far from being unimportant how the observed differences are interpreted as well as to what mechanisms their emergence (or reproduction) are attributed. On the basis of the empirical argumentation pursued so far, we recommend the following interpretation.

The massive subsidization of certain industries and part of the big enterprises with sizable capital stock through fiscal redistribution is an undeniable fact. In our opinion, however, this cannot be explained so that the government is partial to certain industries or to big enterprises with sizable capital stock in an irrational way, or simply that these sectors or big enterprises are *always* able to squeeze subsidies out of the state budget through exercising political pressure, but rather by the fact that the *subsidized sectors or big enterprises with sizable capital stock* are most likely to belong to the *inefficient and depressed* area of the economy. As for the lobbying mentioned earlier, insofar as it is not fragmentary, as suggested by the *(d)* hypothesis, but organized around sectors or enterprise groups, it certainly is an important precondition for obtaining state subsidies. More precisely: a necessary but not sufficient condition, that is, in case of its absence there is not much hope for obtaining the subsidies in question but, on the other hand, not even strong lobbies are able to extort protectionist measures from the authorities without the presence of an acute crisis. Our hypothesis therefore reads as follows:

Strong lobbies are organized in the fields of economic activity regarded as important by the macroeconomic control and management,* in those sectors of the economy which function inefficiently or which are the centers of lasting or periodically returning crises of the socialist economy. Similarly to these critical areas, also the lobbies are most likely to be recruited from certain sectors or from the circle of big enterprises with sizable capital stock and, accordingly, are organized at industrial level or at the level of big enterprises. In our opinion, the general rule of lobbying in this case is not that the lobbies are able to obtain state subsidies *at any time* (presumably they are not), but rather that they can serve as a quick and comfortable *political instrument* for bridging the crisis, once the concerned areas have become inefficient or got into a critical situation. Actually, in a centrally planned economy, this mechanism is badly needed since the *market channels* for the flow and reallocation of capital are practically missing. This is the reason why the state budget, in the case of losses, can always be efficiently blackmailed by threatening with the nightmare of stoppage in production, underutilization of productive capacities due to shortages, bankruptcies and subsequent lay-offs. To avoid this, the state budget rather keeps on paying. In fact, one of the specific features of redistribution under socialist conditions seems to be that it is aimed at *financing the firms' deficits*.** The levelling of enterprise incomes is not the

* Of course, our statement relates exclusively to the circle of the enterprise sector which is important from the point of view of the macroeconomic control and management either because disturbances in the given area would sooner or later spill over to a considerable part of the economy (e.g. in the case of widely used inputs), or because these disturbances would threaten the reaching of macro-level targets (e.g. export targets).

** Redistribution based on financing deficits means that the government channels the subsidies to be allocated within the profit-oriented sphere primarily to loss-making companies. The other extreme case of redistribution is when subsidies are mainly available for profitable firms. This case may be called "redistribution based on active subsidization policy". However, this type of redistribution should not be overly idealized either. State subsidization, whatever form it has—direct subsidization, tax rebate, legal restriction of competition, introduction of complicated market entry barriers of presciption of compulsory inter-firm connections—may sometimes lead to exceedingly adverse consequences in these cases as well. In each such case, an empirical analysis is required to decide whether the subsidization of particular industries, companies or groups of companies—however profitable they are—as well as the resulting *monopoly gains* are or are not coupled with, possibly indirectly acting and unintended, harmful side-effects. (Such might be i.e. the destruction of competitors, upsetting of equilibrium prices or proliferation of monopolistic dictates *objective* of the macroeconomic management, but rather the hardly evitable *consequence* of financing enterprise deficits.

III. What do interfirm wage differentials depend on?

After this rather long but, from the point of view of our topic, by no means irrevelant digression, let us tirn back to our primary subject: what do interfirm wage differentials depend on? The analysis so far suggests that it depends neither on balance sheet profit nor on pre-tax/pre-subsidy profit. It is necessary therefore to look after other explanations. We will examine two major families of hypotheses in detail: on the one hand, the consequences of *labour market segmentation,* that is, the consequences of those decentralized labour *market* effects manifesting themselves at firm, industrial or occupational levels, which divide the demand and supply sides of the labour market into more or less separate submarkets. On the other hand, we will explore the effects of those vertical bargaining mechanisms (those *bureaucratic* effects, for short), which may also contribute to the uneven inter-firm or inter-industrial distribution of relative gains and losses appearing in the wage level. As we shall see, the market and bureaucratic effects in question are not independent of each other. But let us proceed step by step!

III. 1. Market effects: the consequences of labour market segmentation

In order to clarify what is meant by the consequences of labour market segmentation on firm-level wages, we will mention, without aiming at completeness, some of those factors which divide the labour market into separate submarkets. In general, it is found that the reason why the labour market falls into separate submarkets is the great number of barriers setting obstacles to labour mobility.* Some

and bureaucratic compulsions). Their aggregate may cause much bigger losses than the yields of state subsidies. As a matter of fact, in some cases it is not at all unlikely, either, that the additional gain, which is erroneously attributed to the effects of state subsidies, turns out to stem just from the fact that enterprises enjoying the favour of the regulatory system or state subsidies actually squeeze out from the market, or at least inflict serious losses on, quite competitive firms (see Stigler [13]). Nor should it be automatically excluded, on the other hand, that in some fields, in spite of the unfavourable side-effects, the active subsidization policy of the government eventually proves to be positive in terms of its net result, that is, it leads to the animation of certain activities, to the acceleration of technical development, etc. Turning back to the main issue, i.e. the difference between the redistribution based on financing deficits and that based on active subsidization policy, it must be recognized that the above possibility cannot be seriously reckoned with under the conditions of such type of redistribution which is permanently in a defensive position and which is based on the pragmatic principle of financing all current deficits.

* On labour market segmentation under the conditions of socialism, from theoretical point of view see Galasi-Sik [6] and Kertesi–Sziráczki [8], whereas from empirical point of view Cukor–Kertesi [3].

of these constraints may be of *cultural* origin: it is striking, for instance, how the sectors, as well as occupations, employing mostly men are separated from those employing typically women. Another group of constraints are in connection with the specific features of the applied techniques, technology and organization of work, consequently with the *quality of labour*. For instance, those areas which require high qualification and provide continuous promotion—that is, a continuous increase in earnings and prestige in consistency with higher age and increasing vocational experience—are markedly separated from those which, on the contrary, rely on unskilled and uneducated workforce, and which are unable to raise individual wages on the basis of age and vocational experience but can do so exclusively as a compensation for bad working conditions (hard work, health hazards, shift-work, overtime, etc.).* Finally, of course, one should not forget about the *regional* labour market barriers either, since even if favourable employment possibilities are offered far away from home, in most cases the costs implied by moving over or commuting keep employees back from changing employer. All these factors, both jointly and individually, tend to create a situation where—even if bureaucratic intervention is left out of account—the demand-supply-wage mechanism operating with the transmission of labour mobility can never function perfectly, and this *also hinders the levelling of inter-firm wage-level differences*. In other words, *this circumstance may explain the differentiation of enterprise wage positions, too.*

Let us turn back to *Table 4*. Regression I in this table gives an opportunity to analyze the consequences of the segmentation of the Hungarian labour market on enterprise-level wages. On *firm level*,** it is found that the influence of the variables reflecting the composition of workforce and residence, both of which manifest the relative separation of submarkets, is fairly strong. On the basis of the standardized regression parameters—in line with expectations—the strongest effect proves to be exerted by the differences in the proportion of sexes. Much weaker is the influence of inter-firm differences in terms of qualification, age structure and working conditions. The effect of the factor of residence (location) is also considerable. Business units operating in Budapest enjoy an advantage of at least Ft 300 over those state companies and cooperatives which have their location elsewhere. It is interesting, however, that there is hardly any difference between towns and villages.***

The consequences of labour market segmentation in terms of differences in the proportion of sexes, the quality of labour and the regional status exerted on the

* In respect of differences in the proportion of sexes and in the quality of workforce, a very significant occupational level separation was pointed out by Cukor–Kertesi [3].

** As for the industrial level, this will be discussed in Section III. 3.

*** In a previous version of this paper it has been pointed out, too, that within the category of towns there is no significant difference between towns of county rank and other towns either.

Table 8

The effect of labour market segmentation in terms of differences in the proportion of sexes, the quality of labour and the regional status-exerted on firm-level wages (on the basis of Model I)

Variables	Average share in sample (percent)	Standard deviation (percent)	Unstandard-ized regression parameter	Effect of a unity change in standard deviation, in absolute terms (Ft)
Composition of workforce				
WOMEN	42.9	25.2	–9.4	237
OLD	17.8	6.7	–8.8	59
AGE	37.2	2.6	29.1	76
QUAL	52.1	17.0	3.1	53
HISKILL	14.9	11.2	4.9	55
SESKILL	19.3	12.8	–1.8	23
HARDW	15.2	14.5	2.4	35
SHIFT	32.9	25.2	2.1	53
OVERT	19.4	17.0	3.3	56
Location				
Budapest		Category of reference		
Town	–	–	–319	–
Village	–	–	–366	

differences in average wages are presented, on a comparable basis, in *Table 8*. On the basis of this table, the following statement can be formulated:

STATEMENT III: *The segmentation of labour market significally influences the average enterprise wages. Specifically, the effect of regional differences is particularly strong, which manifests itself primarily in the difference between firms with their seat in and outside Budapest. The magnitude of wage differentials owing to the different staff composition of enterprises in terms of sexes is considerable, too. This practically means that wages in companies employing mostly women lag behind those employing typically men. The effect of segmentation relating to the quality of labour is, however, much weaker.*

III. 2. Bureaucratic effects: forced wage adjustment to labour shortage

That part of wage gains which is obtained by companies, company groups or sectors (in some cases, by occupational groups) through formal or informal bargaining mechanisms—i.e. through the representatives of their interests or by informal lobbying—are termed as gains traceable to bureaucratic effects. These gains may be won by companies, company groups, industries or occupational groups that are able to succesfully exercise pressure on those authorities of macroeconomic control, management and regulation which, to some extent, are responsible for the sound—or, at least, relatively undisturbed—functioning of the given area. There are two major instruments available to these authorities to provide companies, company groups, industries or occupational groups with this type of bureaucratic gains. One of them is the instrument of *central wage increases* affecting large aggregates (industries or occupations), while the other—relating mostly to companies or company groups—is the instrument of *tax reliefs* with the aim of creating a "cover" for firm-initiated wage increases.

In this paper, we have no opportunity for analyzing the empirical rules of thumb of the application of these two instruments in detail. It is all the more so because, in any case, it would require a dynamic analysis covering a longer period of time,* since, in all likelihood, it is the longer-term *accumulated* impacts of central wage increases and tax reliefs which appear in the differences of firm-level wages. So, our interpretation can only be *hypothetical*. Accordingly, that part of enterprise wage differentials which is stemming from the effect of *company size, ownership* and *industrial status*, can be traced back to the above-mentioned vertical bargaining processes, more precisely, to the accumulation of bureaucratic effects in the above defined sense. Of course, this also implies the assumption that the allocation of central wage increases and tax reliefs does have a more or less stable pattern over time, which means at the same time that a particular circle of companies and industries *regularly* benefits from the bureaucratic gains in question**—and with a higher probability than other companies and industries.

Before turning to the discussion of how, through what mechanisms and especially on what motivations these bargaining procedures take place,—on part of the companies and industries, as well as of the organs of macroeconomic control and management—let us first evaluate the magnitude of the effects under consideration on average enterprise wages. We will analyze the consequences of three types of effects in detail, namely those of 1. company size, 2. industry and 3. ownership.

* In their present form, our data are not applicable for this purpose.

** As mentioned earlier, in the absence of suitable data, this assumption cannot be verified. On the other hand, however, there is an indicator available for 1980 which reflects the amount of tax reliefs for wage increases received by enterprises under various pretexts. For describing the regularities prevailing in the allocation of tax reliefs for wage increases, a regression equation has been set up as well, the independent variables of which are—with negligible difference—the same as those of Model I of *Table 4*. Although the multiple correlation coefficient is relatively low ($R^2 = 0.119$), the model does not contradict our expectations: in the allocation of tax reliefs, company size and industrial status actually play a very significant role.

As for the effect of *company size,* Model I of *Table 4* indicates a slightly positive linear relationship (0.031) between capital and wage level, while a slightly negative linear relationship (-0.013) between the number of employees and wages. However, the effect of factors of production is better characterized by Table 9 which contains the regression parameters belonging to the caterogized values of the variables of capital and employment.* The data of this table strongly refute the widespread view that it is the big companies—big in terms of both capital and employment—which are in a favourable wage position compared to other enterprises. Strange enough, the largest firms (employing more than 5000 workers and fixed assets worth more than Ft 1 billion) have virtually the least advantage. Moreover, they are in an unfavourable wage position compared, for instance, to the companies with 100 to 500 employees and with fixed assets worth Ft 50 to 100 million—at least, due to their size. This does not mean, however, that small enterprises are in a better position in general. What is suggested by the data is rather that the companies having an advantage are those which apply a *capital-intensive* technology, that is, those in which *workers operate capital goods of relatively high value*. How can this be interpreted? The following explanation seems reasonable. Bureaucratic gains granted in the form of central wage increases or tax reliefs are obviously more readily available for companies or company groups with strong bargaining power, that is, for those which can exercise serious pressure on the authority competent to approve wage increases. In the course of bargaining for wage-increasing possibilities, in turn, it may be a very efficient trump—particularly under the conditions of *labour shortage*—if an enterprise is able to threaten with the risk of *underutilizing a massive capital stock*.**

In an earlier version of our study, we pointed out *industrial status* as the factor most intensively influencing inter-firm wage differentials. On this subject, several critics raised the objection that the influence of industrial status on enterprise wage positions is merely spurious, and it is only true insofar as the industrial differences reflect those prevailing in the composition of workforce among enterprises. Actually, this objection has urged us to set up—by combining different types of data—such a database, or set of variables, which, at least within the frameworks of cross-sectional analysis, provides opportunity for testing almost each relevant hypothesis—including this latter one, i.e. the sectoral status *versus* composition of workforce hypothesis.

* The variables included in the regression equation are identical with those of Model I in all other respects.

** It should be noted that the seemingly most obvious *alternative* explanation—which would derive the positive correlation between the capital/employment ratio and firm-level wages from the positive relationship between the capital/employment ratio and qualification, leaving the specific institutional features of resource allocation in socialism out of account—is automatically excluded by the fact that in *Table 9* the regression parameters belonging to the values of variables of capital and employment have been taken from an equation which also includes variables reflecting the qualification level of companies. Accordingly, the effect of qualification has already been eliminated from the impact of capital and employment.

Table 9

The non-linear effect of company size on enterprise-level wages

Number of workers	Unstadard-ized regression parameter (t-value)	Capital (Ft million)							Total
		–10	10–50	50–100	100–200	200–500	500–1000	1000–	
		Unstandardized regression parameter (t-value)							
		–370* (–6.6)	–240* (–5.1)	–145* (–3.5)	–50 (–1.3)	Reference	+147* (3.8)	+266* (4.9)	
–100	+192** (1.8)	–178 (N=6)	–48 (N=5)						(N=11)
100–500	+195* (4.9)	–175 (N=151)	–45 (N=540)	+50 (N=133)	+145 (N=44)				(N=868)
500–1000	+126* (3.8)		–114 (N=63)	–19 (N=112)	+76 (N=92)	+126 (N=59)	+273 (N=21)	+392 (N=7)	(N=354)
1000–2000	Refer-ence			–145 (N=31)	–50 (N=50)	0 (N=75)	+147 (N=39)	+266 (N=17)	(N=212)
2000–5000	–73** (–1.9)					–73 (N=87)	+74 (N=55)	+193 (N=34)	(N=176)
5000–	–252* (–3.6)					–252 (N=3)	–105 (N=4)	+14 (N=37)	(N=44)
Total		(N=157)	(N=608)	(N=276)	(N=186)	(N=224)	(N=119)	(N=95)	(N=1665)

Note: The values of parameters belonging to other variables are not significantly different from those presented in *Table 4* (Model I): $R^2 = 0.738$.

$^*p \leqslant 0.001$, $^{**}p \leqslant 0.01$.

We will again rely on the regression parameters belonging to Model I of *Table 4*. These suggest that the sectoral differences are *independent* and by no means insignificant sources of inter-firm wage differences. As compared to companies of the engineering industry considered as a reference category, enterprises in mining and metallurgy enjoy a wage advantage of more than Ft 1900 and nearly Ft 800, respectively. Only 21 percent of the Ft 1600 difference in wage-level between metallurgy—employing typically men—and commerce—employing typically women—is due to the sizeable difference in the men/women ratio between these two industries (61.2 and 25.8 percent, respectively), whereas some 60 percent can be attributed to pure industrial effect.

What is actually meant by "pure industrial effect"? How can a sector achieve that, *independent* of the composition of its workforce and the structure of its companies by size, ownership relations, location and profitability, it can secure its employees a substantially different wage level than another industry? Our interpretation is as follows. The intensity of labour shortage is not even across the various areas of the economy: the different industries are affected by the shortage to a significantly varying extent. This is primarily explained by the fact that the various industries are different in respect of the proportion of attractive, high-prestige jobs with good professional prospects and declining jobs with low prestige and no professional prospects they can offer. Similarly, the various industries are also different in respect of the extent to which they offer good working conditions and jobs requiring high qualification and education or, on the contrary, jobs involving hard manual work, health hazards, shift and overtime work. Insofar as an industry has a stronger-than-average demand for *declining professions* or it concentrates a major part of its demand for labour on jobs neglected by workers because of the *bad working conditions* they offer, furthermore, if the demand for its output is stable or increasing and the products in question are not available from imports, an adjustment process to animate the *supply* of labour is immediately set into action on the initiative of both the companies constituting the given sector and the authorities responsible for its smooth operation—an adjustment process described by János Köllő in his study on adverse selection in the socialist labour market.*

In this case—strange enough—the situation in the *commodity market* also amplifies the bureaucratic effects. This is because the more intensive the labour shortage under these circumstances, the more difficult it is to meet the demand of the given industry's customers. And the more intensive the resulting shortage of the products of the industry concerned, the more likely it is that customers are inclined to exchange a decrease in waiting time for an increase in the price level. This is all the more true because they can almost automatically shift the increase of prices of inputs onto

* See Köllő [11].

their customers in the prices of their products. In this way, the authority responsible for approving wage increase in the industry struggling with labour problems gets under pressure from two sides: representatives of the given industry urge the solution of labour problems, while its customers demand the elimination of supply problems. Thus, the industry in question has very strong arguments in the course of fighting for central wage increases or tax reliefs since, besides the difficult situation of its own companies, it can also make use of the complaints of its unsatisfied customers in support of its needs.

The empirical support of the above interpretation required a new regression model. This is because, on the basis of Model I, the parameters indicating the bargaining power of industries cannot be explained by industrial differences in working conditions (more precisely, by the resulting differences in the intensity of labour shortage), since—due to the nature of linear regression—the linear effect of variables of working conditions has already been *elminated* from the effect of industrial dummies. But this is the crux of the matter. It is only the *linear* effect of the variables in question which has already been elmininated—the effect which is *equally strong* in the case of all enterprises, *independently* of industrial differences. Thus, we have set up such a model as well in which—leaving all other factors unchanged—the industrial variables, the variable of HARDW (the percentage share of those performing hard work) among the variables of working conditions, as well as the variable of QUAL (percentage share of workers having formal qualification) among those reflecting qualification have been replaced by (INDUSTRY * HARDW) and (INDUSTRY * QUAL) multiplicative variables representing the *joint* effect of industrial status *and* hard work as well as industrial status *and* qualification, respectively.* These variables, suitable for measuring interaction effects, help recognize whether the industrial status of firms has any remarkable impact on compensation for qualification or bad working conditions. If the answer is yes, this means that *certain industries possess stronger bargaining power* than others in the course of bargaining with the authorities for a higher compensation for the qualification of employees or for adverse working conditions.

Columns (3) and (5) of *Table 10,* which contain the parameters belonging to the newly constructed variables, show that industrial differences are highly significant in respect of compensation for both qualification and hard work. For instance, in the case of two companies, one belonging to metallurgy and the other to the construction

* The procedure has had no remarkable impact on parameters of other independent variables (the respective t-values in parantheses): CAP = 0.0305 (2.8), EMPL = −0.0217 (−3.1), OWN = 172 (7.8), BALPROF = 0.4187 (4.7), TOWN = −332 (−15.8), VILLAGE = −391 (−14.5), WOMEN = −10.6 (−19.3), OLD = −6.7 (−3.5), AGE = 19.8 (3.7), HISKILL = 5.7 (6.4), SESKILL = −2.9 (−3.6), SHIFT = 2.3 (5.3), OVERT = 3.0 (5.4), R^2 = 0.746. Compare with the parameters of Model I *Table 4)*! The level of significance is not worse than $p \leq 0.01$ at each parameter).

Table 10

The relationship between successful industrial lobbying and labour shortage stemming from adverse working conditions

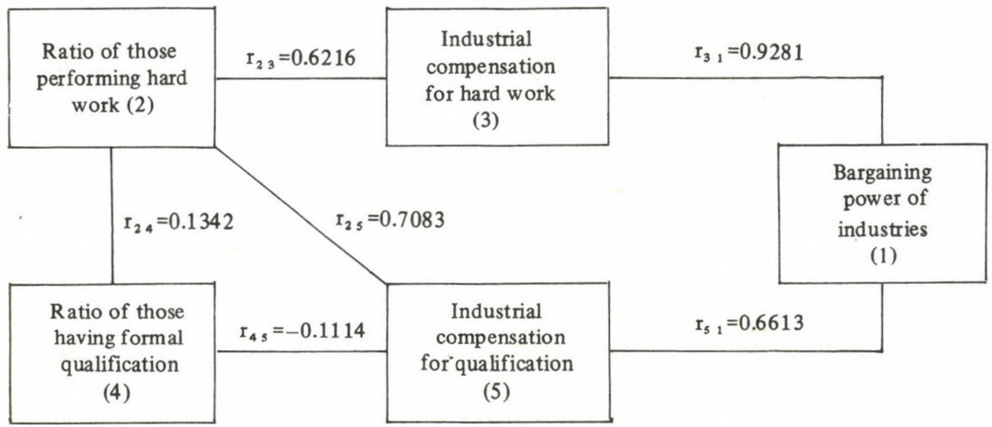
Industry	Bargaining power of industries[a)] INDUSTRY (Ft) (1)	Ratio of workers performing hard work[b)] HARDW (percent) (2)	Compensation for hard work in the industry concerned[c)] (INDUSTRY * HARDW) (Ft/percent) (3)	Ratio of workers with formal qualification[b)] QUAL (percent) (4)	Compensation for qualification in the industry concerned[c)] (INDUSTRY * QUAL) (Ft/percent) (5)
Mining	1943	42.6	36.2 (7.5)*	61.6	8.8 (2.5)⁺
Metallurgy	780	27.1	10.4 (2.2)⁺	41.6	12.5 (3.9)*
Transport	256	13.0	4.3 (1.5)⁺⁺	50.4	3.6 (3.0)**
Chemical industry	255	14.9	2.9 (0.7)	42.1	6.1 (3.6)*
Food industry	221	24.0	–2.3 (–1.3)⁺⁺	41.3	7.8 (6.5)*
Electric energy industry	201	23.8	–7.5 (–1.2)	59.9	7.6 (2.7)**
Construction industry	171	27.0	4.1 (3.7)*	61.5	2.0 (2.9)**
Construction materials					2.5
industry	81	30.5	1.3 (0.4)	33.9	2.5 (0.7)
Wood, paper and printing industries	21	11.3	4.7 (1.2)	45.8	–0.2 (–0.2)
Engineering industry	0	9.0	0.0 –	57.9	0.0 –
Textile and other industries	–55	5.8	0.7 (0.3)	43.6	–0.1 (–0.2)
Commerce	–156	14.0	–2.5 (–2.3)⁺	57.3	–0.8 (1.5)⁺⁺

a) Regression parameters belonging to the INDUSTRY dummies of Model I.

b) In the representative company of the given sector such ratio is accounted for by the workers performing hard work as those having formal qualification (unweighted averages).

c) The interaction effect of INDUSTRY with HARDW as well as with QUAL. Regression parameters belonging to the product of these variables. The regression equation is different from that of Model I insofar as the variables of INDUSTRY, HARDW and QUAL have been replaced by the variables of (INDUSTRY * HARDW) and (INDUSTRY * QUAL). The respective t-values in parantheses.

*$p \leqslant 0.001$, **$p \leqslant 0.01$, $^{+}p \leqslant 0.05$, $^{++}p \leqslant 0.20$.



r_{ik} = correlation coefficient between the i-th and k-th *industrial level* variables.

industry, both of which employ 25 percent of workers for hard work, and which are similar in all other respects as well, an average wage gain of (Ft 10.4/percent—Ft 4.1/percent) * 25 percent ≈ Ft 157 appears to the advantage of the metallurgical company just because hard work is much better compensated in metallurgy (Ft 10.4 percent) than in the construction industry (Ft 4.1/percent).

As for the relationship between the differences in compensation for adverse working conditions (hard work) across the various industries and the "pure" industrial differences, the validity of our hypothesis seems to be proven. This is evidenced by the extremely strong positive correlation between these two industrial level variables (r_{31} = 0.9281). At the same time, a fairly strong positive correlation is found between the bargaining power of industries and the industrial level compensation for qualification, too (r_{51} = 0.6613). Nevertheless, this does not refute our interpretation, since the point is not that qualification is better compensated in industries employing highly qualified labour, while worse in those emplyoing low-skilled labour—as a matter of fact, the industrial differences in compensation for qualification are practically independent of the qualification level of the various industries (r_{45} = −0.1114). They are not independent, however, of the industrial differences in working conditions. Surprisingly, qualification is better compensated precisely in those industries where working conditions are bad, and worse in those where they are good (r_{25} = 0.7083). Similarly, adverse working conditions are appreciated in those areas where the ratio of jobs involving hard work, health hazards and other dangers as well as requiring occupations generally dispreferred by employees is higher than the average (r_{23} = 0.6216). All in all, *both* adverse working conditions *and* qualification receive higher compensation in industries with bad working conditions than in the overall economy. This is the factor which explains the majority of industrial differences in bargaining power. It must be recognized that in this way the "pure" industrial differences among enterprises have been traced back to such variables which may be brought up—in the course of the bargaining process between the companies (industries) and the authorities—as a "just" argument in support of their wage-increasing efforts as well as a "legitimate" justification of decisions by the macroeconomic agencies yielding to enterprise pressure.

The appraisal of the so-called *ownership effect* has been left for the end. This, as can be derived from *Table 4,* means a difference of Ft 185 between state-owned companies and cooperatives in favour of the former, which unambiguously reflects the weaker bargaining position of cooperatives in the vertical bargaining process with the authorities. Summarizing the most important findings in connection with the effect of vertical bargaining mechanisms shaping inter-firm wage differentials, the following statement can be formulated:

STATEMENT IV: *The differences in enterprise wage positions are strongly influenced by firm or industrial level bargaining with the authorities as well. The success of bargaining, under the conditions of wide-spread labour shortage, is in fact guaranteed by two kinds of bargaining instruments: by threatening with the danger of unutilized capacities of great value on the one hand, and with the emergence of supply disturbances of hardly substitutable commodities on the other hand. The first of these instruments is made use of by firms employing capital-intensive technologies and suffering from labour shortage, while the second is the trump of companies of those sectors where working conditions are bad and there are no promotion prospects for employees. The latter firms have to face a gradually shrinking supply of labour while, at the same time, they produce hardly dispensable commodities.*

III. 3. The joint presence of market and bureaucratic effects at industrial level

What characterizes the relative strength of the effects of the wage determinants analyzed so far? What is the decisive factor in the determination of average wages: the segmentation of the labour market or the industrial lobbying striving for bureaucratic gains? The available data provide an opportunity for making this comparison at the *industrial* level. This is because once the magnitude of deviation of industrial wages from the overall average of the economy (i.e. the advantage or disadvantage of the various industries in terms of wages) has been determined for each industry, it becomes possible to express the *sources* of the advantages or disadvantages in question in quantitative terms (i.e. as a percentage of relative wage level differences).

Specifically, the industrial wage gains and losses can be broken down into components, by means of the regression parameters and the differences of industrial average and sample mean, for each independent variable. These components have been aggregated into three groups—the effect of profitability, the effect of labour market segmentation and the bureaucratic effect—and then expressed as a percentage of the respective industrial wage gains or losses. As it has turned out from our earlier analysis, too, the effect of profitability is almost completely negligible: except in one case (chemical industry: 9 percent) it never exceeds 4 percent of the magnitude of advantages or disadvantages. It is justified therefore to put the question in this way: is it the segmentation of the labour market or, rather, the bureaucratic gains which determine the relative wage position of the different industries? In other words, returning to the primary question raised in the introductory section of this paper: has the regulatory system, which—although frequently changing—has remained profit-oriented in official declarations ever since 1968, succeeded at least in breaking the impact of the earlier periods' bureaucratic control and vertical bargaining mechanisms?

In *Figure 2*, the magnitude of wage gains and losses of the various industries

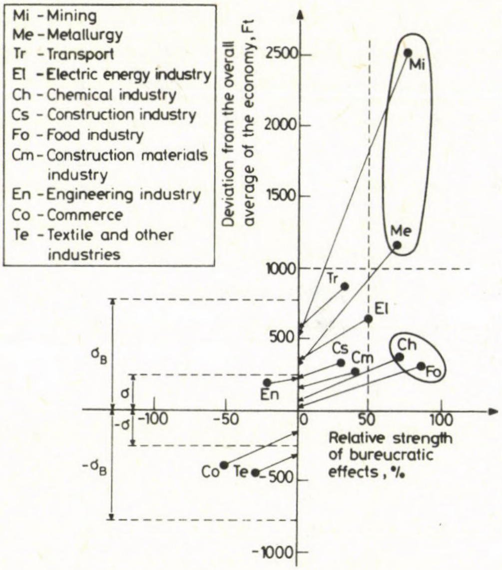


Fig. 2

Industrial wage positions as a function of the strength of bureaucratic effects

relative to the average of the national economy is expressed as a function of the relative strength (in percent) of bureaucratic effects. While the vertical axis requires no comment, the horizontal seems to need some. What justifies the extension of the horizontal axis in negative direction is the possibility that the *direction* of bureaucratic effects as well as those of labour market segmentation may also be opposite to each other (even if, from an empirical point of view, it is fairly improbable). As a matter of fact, *no analytical arguments suggest* that the direction of the effects of bureaucratic interventions should necessarily be identical with those of labour market segmentation. The fact that the direction of labour market and bureaucratic effects is the same in all sectors (except for engineering) testifies that what state interventions actually do in the labour market is the amplification of already prevailing differences in enterprise and industrial positions stemming from segmentation of the labour market. In other words, relative to the overall average, they *further increase* both the advantages and disadvantages (gains and losses). Those sectors which, owing to the composition of their workforce and their regional distribution, offer a wage level higher than the average of the national economy will remunerate their employees even better thanks to state interventions; whereas the industries below the average wage level of the economy will pay even less. Expressing the part of the industrial differences stemming from segmentation of the labour market as well as from bureaucratic effects in absolute terms, a fairly strong positive correlation is found between these two industrial level variables (r = 0.65). This is what we meant in the introductory part of this section by saying that market and bureaucratic effects are not independent of each other. Furthermore, while the absolute range of industrial differences, including the bureaucratic effects, is nearly Ft 3000, their exclusion would reduce the range to a mere Ft 860 (see industrial positions belonging to the zero value of bureaucratic effects in *Figure 2*).

The bureaucratic effects, at the same time, do not amplify inter-industrial differences to the same extent. *Much more favourable* than average wage positions, for instance, are not too likely to attain without extensive state intervention, that is, without successful lobbying of the companies of the given sector and without administrative actions (central wage increases and tax reliefs)—as a result of yielding to these pressures. And *vice versa:* the industries which owe their favourable wage position primarily to bureaucratic preferences are just those which are the most likely to have the strongest trumps against the state budget. These are the industries which operate capital-intensive technologies, implying that labour shortage would lead in their case to underutilization of equipment of particularly great value, and/or those which have to face a massive outflow of the workforce owing to the lack of promotion prospects and adverse working conditions, producing, at the same time, hardly dispensable goods "for the national economy". Mining and metallurgy may be good examples of the case when a sector hit by a particularly intensive labour shortage derives its bargaining power from the circumstance that it produces widely used inputs, the shortage of which would cause recession in several other areas of the economy as well. On the other hand, the food industry, chemical industry and metallurgy may adequately illustrate the case when an industry seeks administrative support for increasing its wage level by arguing that, else it is unable to meet the targets enjoying macroeconomic priority (e.g. exports).

But, whichever is the case, the following statement may be considered as generally valid:

STATEMENT V: *The vertical bargaining with the authorities is a very significant source of industrial wage differentials. The wage level of the various industries disperses in a three times as wide range with the inclusion of bureaucratic effects (σ_B = Ft 780) as without them (σ = Ft 250). The administrative interventions manifesting themselves in bureaucratic effects are usually called forth by short-term tensions of the economy. Accordingly, in respect of this very important type of state interventions concentrating on labour market developments, the decisions taken by the authorities are practically not autonomous, whereas they are not in line with the long-term objectives of the macroeconomic planning either. Central wage increases as well as the tax reliefs supporting enterprises in their wage-increasing efforts can rather be qualified as a* *defensive adjustment policy of the fiscal authorities to the short-term tensions of the labour market—that is, to the tightening of labour shortage in those areas which the macroeconomic planners cannot or dare not leave in the lurch, owing to the rigidity of their preferences in respect of the production, export or any other physical targets.*

V. In lieu of a summary: some thoughts on the similarities between fiscal redistribution of enterprise incomes and bureaucratic adjustments prevailing in the labour market

Fiscal redistribution based on financing deficits on the one side, forced wage adjustment to the labour shortage with administrative assistance on the other. What common features can be observed? The case by no means is that the winners and losers of the fiscal redistribution of enterprise incomes are necessarily identical with the winners and losers of the bureaucratic allocation of wage-increasing possibilities. As often as not, there is no coincidence. For instance, in 1980, a considerable part of tax reliefs for wage increases was channelled to mining, whereas it was this very industry from where the highest amount of income per firm was taxed away. The common features lie deeper than that; they rather appear in the specific *method* by which the enterprise incomes and wage-increasing possibilities are redistributed and reallocated, in a way described below.

The redistributive processes are called forth by the short-term current tensions of the economy in both cases. This is because, under the given circumstances, it leads—even in the short run—to a critical situation in the fiscal redistribution of incomes if massive enterprise losses emerge, whereas in the administrative reallocation of wage-increasing possibilities the situation becomes critical if capital goods of great value are partly or fully unutilized, or "macroeconomically important" physical targets are not met. In such a situation, the state plays a passive role in respect of both the redistribution of incomes and the reallocation of wage-increasing possibilities. Fearing incidental supply problems and lay-offs, it never lets loss-making companies go into bankruptcy; it never lets equipment of great value be unutilized. Also, it rigidly insists on its certain supply responsibilities and physical targets. Thus, the state is always forced into a defensive position vis-à-vis the companies being inefficient or facing labour shortage—and making use of the above listed arguments. In this way, redistribution and reallocation can be nothing else but a quasi-automatic bureaucratic adjustment process reacting to the strongest prevailing pressure.

These quasi-automatic adjustments are accompanied, at the same time, by consequences of adverse selection—by the levelling of enterprise incomes as well as a considerable overcompensation in the labour market of areas with declining professions and adverse working conditions. As a result, profitable companies are not interested in increasing their profits (since the resources produced by them are taxed away to cover losses emerging elsewhere), while loss-making firms in strong bargaining position are not really interested in eliminating their losses either, as they are able to shift the consequences of their inefficiency on to the state budget. Since redistribution based on financing deficits involves micro-level motives implying divergence from equilibrium positions, it continuously reproduces its own necessity. The same holds true of the reallocation of wage-increasing possibilities, too. The overcompensation of declining professions and sectors with adverse working conditions is generally inappropriate for driving labour market processes to an equilibrium path in areas critical for the macroeconomic planning. In most cases, it is only sufficient to achieve that the intensity of labour shortage be maintained at, or reduced to, a sustainable level. However, since it can only cope with this task at increasing costs, it also unintendedly contributes to the gradual deterioration of the relative wage position of those areas (occupations, company groups or sectors) which are normally left out of wage increases, thus creating the potential sources of future interventions of similar character.

Giving a *summary* of what has been discussed so far, we arrive at the following conclusions. The fiscal redistribution of enterprise incomes as well as the administrative reallocation of wage-increasing possibilities are basically called forth by the short-term tensions of the economy. In these kinds of redistributive roles, the state acts rather passively than actively: companies having a strong trump in the vertical bargaining processes are most likely to force it into a defensive position. As a result, fiscal redistribution and reallocation are nothing else but a quasi-automatic bureaucratic adjustment process reacting to the strongest prevailing pressure. These adjustments, however, are accompanied by the consequences of adverse selection, too. They fail to facilitate the achievement of equilibrium positions, whereas they involve ever higher costs. Through its interventions in response to the pressure by companies with strong bargaining power, the state is forced—just like a passionate gambler—to go into higher and higher expenses, to run after its money. And this is quite understandable as long as the behaviour of enterprises as well as the attitude of the state toward them are essentially determined by motives of meeting needs or principles of household management.

"The basic types of every economy are the *household* and the *enterprise;* although transitional stages join one to the other, yet they are diametrically opposed in their pure form as notions. *Household* means an economy that is directed to meet its needs, just the same, whether they be the needs of a state or an individual... As opposed to the household, *enterprise* is motivated by chances of profit, more exactly, by chances of profit through exchange."*

Household-like management or profit-motivated enterprise—after all, these are the only options to choose from: either the one or the other.

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* "Die beiden Grundtypen aller Wirtschaft sind *Haushalt* und *Erwerb,* die zwar durch Übergangsstufen miteinander verbunden, in ihrer reinen Form aber begriffliche Gegensätze sind. *Haushalt* bedeutet ein Wirtschaften, das an der Deckung des eigenen Bedarfs orientiert ist, sei es des Bedarfs eines States, eines Individuums... *Erwerb* dagegen heisst Orientierung an Gewinnchancen, und zwar an Tauschgewinnchancen." Weber [14] p. 6.

РАЗЛИЧИЕ ВО ПЛАТЕ ТРУДА НА ВЕНГЕРСКИХ ПРЕДПРИЯТИЯХ: СИТУАЦИЯ И ВЫВОДЫ

Г. КЕРТЕШИ—Э. ЦУКОР

На основе широкого круга эмпирических данных авторы статьи делают попытку объяснить с помощью статистического анализа различия в средних заработках на уровне предприятий. Их важнейшие выводы следующие: 1. На различия в средней заработной плате по предприятиям разница в прибыльности предприятий воздействия практически не оказывает. 2. Указанные различия по существу объясняются двумя факторами: сегментацией рынка рабочей силы и совокупным воздействием бюрократических плюсов и минусов, связанных с централизованным повышением заработной платы и налоговыми льготами. 3. Сила этого бюрократического воздействия — которое рассматривается авторами как необходимость вынужденного приспособления заработной платы к дефициту рабочей силы — весьма велика даже, как это ни странно, и в пореформенной хозяйственной системе. 4. Из общих особенностей перераспределения доходов предприятий и вынужденного приспособления заработной платы к дефициту рабочей силы авторы в первую очередь указывают на пассивную роль государства, выражаюшуюся в том, что государственное вмешательство и в той и в другой области вызывается краткосрочными напряженностями в экономике. В такой интерпретации государственное вмешательство — это не что иное как псевдобюрократическое приспособление к тому давлению, которое в данный конкретный момент ощущается наиболее сильно.

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TRANSFORMATION OF INDUSTRIAL ORGANIZATION—WITHOUT GENUINE CHANGES

P. VINCE

The study discusses the reorganization of large enterprises and trusts. With this measure an amalgamation process is replaced by organizational decentralization. These are measures whose direction would also be a condition of continuing the reform. The study analyses the viewpoints of selection which determined the course of reorganizations. Investigation of the administrative decisions and of the conflicts of interests behind them show that, for handling the changes made up to now in a narrow scope, economic control was not compelled to revalue its relations with the enterprises. Thus, the loosening of rigidities of the organization in itself—if the system of economic control remains unchanged—does not expand the scope of movement of the economic entities, thus it does not produce any considerable change in their performances and in their ability to adjust.

In the 1980s a new tendency of organizational changes, different from earlier ones, began in Hungarian state-owned industry. In recent decades, enterprises have been increasing in size, while their number has been decreasing, as a result of a series of mergers. In an international comparison, the distribution by size of Hungarian industry appears to be rather concentrated. Contrary to international tendencies, large-scale enterprises—not medium—or small-scale ones—are predominant in Hungarian industry. [1] Therefore, the organizational decentralizations which started in 1980 represent a new phenomenon. As a result of this trend a few trusts and large-scale enterprises have been divided, and certain units of the remaining large enterprises have been made independent economic units.

Beside reorganization, other changes affecting enterprise organizations have also taken place in recent years, and the central organizations of industrial management have been transformed as well. New forms of enterprise management and organization have been developed and introduced. [2] Of these changes, the present article will discuss the decentralization in the industrial organization.

The reason why the changes in industrial organization deserve attention is that, by increasing the number of economic units, the *authorities have now introduced measures which happen to be in line with the objectives of carrying further the progress of economic reform*. Hungarian economic literature provides detailed and comprehensive analyses of the problems rooted in an overcentralized industrial organization. These are manifest in poor enterprise adjustability, and the constant tensions of management. [3].

Thus there is a question of whether reorganizations have an influence on the system of economic control and management. The question has two aspects. First: what is the daily practice of central economic management in handling reorganizations and the problems they cause? Second: how much are transformations restrained because reorganizations are taking place without making the reform process more comprehensive and without increasing enterprise autonomy?

Centralized organizations were dissected or dissolved by authorities—in other words the selection of enterprises and their reorganizations did not take place as a result of an organic development process such as market selection, but following decisions made by the public administration. Of course the changes are different in the two cases. However, authorities had to take the initiative because of the lack of effective market forces. This situation gives rise to a contradiction which has to be faced in every reform step i.e. when transformation has started from and was directed by the top-level. Are the central authorities able and willing to let the transformation—which may weaken their positions and power—go so far that changes should be more than formal? The dilemma is, in other words: what chances exist for market factors to assert themselves and to extend the scope of their influence, if the changes are not determined by market criteria? There is also a question whether such types of organizational decentralization offer a viable answer to the challenge of the required higher standard of performance, and adjustment to the market by the enterprises.

Preparations for transforming the industrial organization were first made in 1979. The first reorganizations took place in the following year. Between 1981 and 1985, though further decisions were made on reorganization, these affected a yearly diminishing number of large enterprises and trusts. More than 400 new enterprises were established, whereas the changes affected less than a hundred large organizations.* Reorganizations mainly consisted of the granting independence to a few factory units; only a few large enterprises and trusts were fully decentralized. Except for the food processing industry, reorganizations were of a narrow scope, leaving intact the enterprise structure of industry. In fact the centralization of the industrial organization was not loosened.

The idea of decentralization was concomitant with the 1979 change in government economic policy i.e. with restricted growth and curbed investments. The economic control agencies expected the bargaining position and interest-asserting ability of the smaller units that came into being after decentralization to be weaker, thus helping to reduce their demand for investment sources. Another motive behind the decisions was the realization of the fact that one of the sources of the tensions that had accumulated in the economy by the late 1970s seemed to be poor enterprise adaptability owing to the overcentralized industrial organization.

* The number of state-owned enterprises (the reorganizations in question took place in this sphere) rose from 699 in 1980 to 956 by 1985, as a result of decentralizations, mergers and liquidations. [4]

Interest relations in the reorganization process

The reorganization process involved the selection of enterprises for reorganization, consideration of feasible organizational solutions, reconciliation of the interests of the affected economic control agencies and enterprises and the establishment of conditions for functioning under the new circumstances. The reorganization measures had the declared purpose of strengthening the enterprises' adjustment to the changed economic policy of the 1970s, by means of establishing a more proportionate enterprise size distribution—including an increase of the number of smaller enterprises. With this in view, reorganization can be justified in the case of large horizontally organized enterprises struggling with economic troubles. These, having absorbed their suppliers to an excessive measure were unable to adjust because of their large dimensions, and also enjoyed a monopolistic position.

The official documents drawn up in preparation for the decentralization also formulated a few general suggestions regarding: the extension of the market sphere, the strengthening of competitiveness on the foreign and on the domestic market, increasing adaptability, and raising incentive. When formulated in more concrete terms, however, these objectives were much less bold. First, they demonstrated that all the authorities expected was that the elimination of a few flagrant organizational disproportions would be sufficient to improve the functioning conditions of the enterprises involved, thus placing consumers in a more favourable position. Second, increasing the number of smaller-scale enterprises could seem, at least formally, a measure apt to contribute to—by a single decision of organizational transformation—the development of an industrial organization better suited to market requirements i.e. consisting of a higher number of, and smaller, producers.

In the course of preparations for the reorganization, there were certain ideas concerning the strengthening of market effects. However, as we shall see, they cannot be said to have had any considerable influence on the process. Contrary to declarations stressing the need for market effects to assert themselves, the roles of the different actors in the process of reorganization were determined by considerations of quite another nature.

The central authorities' attitude towards the reorganization

The inevitability of the reorganization, its effectuation, and the changes in industrial organization stirred up many different interests. The changes in question obviously did not leave intact the position and scope of action of the authorities and enterprises taking part in the process. Therefore, the reorganization offers a good opportunity to observe the participants' interests and attitudes.

A number of different considerations motivated the position of the central authorities (which were the ministries of different branches)—that is, the central organs in direct control of enterprises. These considerations were characterized by an insistence on an unchanged organizational framework. Their position was determined, on the one hand, by their relations with enterprises, i.e. by the conditions of their control over the enterprises; and on the other hand, by their judgement of the changes that were to take place in their relations with other authorities.

Reorganization causes a change in the central authorities' relations with enterprises. First, they have to face the fact that the direct control of the enterprise sphere through large enterprises will grow narrower. This is something central organs consider as the basic condition enabling them to arrange for central priorities to be fulfilled. Second, the position of a central authority in relation to another one may be weakened. One component of such a position is the reference-basis the enterprises present for their central authorities in the various issues in the course of preparing of and bargaining on decisions to be made. Reference to large organizations and to their significance in the national economy (owing to their size) are important parts of the set of arguments of the central authorities. This is also shown by the fact that, mainly in the industry, these authorities did not just insist on maintaining their own large organizations, but they supported decentralization of the large enterprises under the control of other authorities.

Besides the intention to weaken one another's bargaining position, however, there are also other considerations; the authorities' attitudes to reorganization were, in a few cases, ambivalent. If, in a certain field, close relations had developed between producers belonging to two different central authorities, the elimination of the monopolistic organization of one could potentially improve the position of the enterprises of the other. Therefore, these authorities could have an interest in the reorganization of large enterprises beyond their own scope of control. Similarly, a central authority making efforts at establishing a successor organization with a limited medium-level control sphere—i.e. not enterprises, but a superordinated centre—after reorganization in its own field, may try to thwart such efforts on the part of other authorities. The reason is the same: its own enterprises have a better chance of asserting their interests if, in the field of the other authority, they can directly contact small independent enterprises instead of a large one.

Curiously, such instances have also been found in which a central authority did not oppose reorganization of its own large enterprise. It might, namely, have come to the conclusion that reorganization could be in the interest of other producers under its control. It could be in the interest of one or another group of enterprises to abolish the superiority of certain large monopolistic organizations and in certain cases the central authority may have identified itself with such an effort. There could be a similar result if a central authority gave priority to the redistribution of spheres of activity and markets among its own enterprises, as against the maintenance of an enterprise. If, for some reason, the authority was dissatisfied with the activities of one of its large enterprises, it could interpret decentralization as a measure of reorganization enabling the alteration of enterprises' activities, and the entry of new producers.

Sources of dissatisfaction were, for example, a permanent deficit, disturbances of cooperation among the units of some large enterprise founded through mergers years before, and, in some cases, the too strong bargaining position of the large enterprise. In such cases, reorganization resulted in a shift of power relations among enterprises, in line with the intention of the cenral authority.

In the central authorities' support for certain reorganizations, a role must have been played by the tactical consideration that a stubborn rejection of all decentralization proposals did not seem to be a position that could be held for long in the bargaining process with the other (financial and planning) authorities. It seemed, therefore, expedient to agree to a few cases of decentralization, i.e. to show willingness toward reorganization they themselves deemed justified. This was in order that, in the rest of the cases, they could act more efficiently and with a view to preserving the organizational framework. It has happened, too, that power relations among authorities have developed in such a way that an authority was forced to accept certain organizational changes which it in fact opposed.

It is clear from the details above that, if the authorities gave their consent to reorganization of their enterprises, it was not due to any intention on their part to strengthen competition on the market. Rather, it was an aspect of their efforts to strengthen their position in the bargaining process going on among the economic central authorities on the one hand, and to improve the chances of some of their enterprises in asserting their interests on the other. Also, they hoped to effectuate a change in the relative strength of their enterprises.

Thus the attitude of the central authorities was not the same with each one of the reorganization proposals. Nevertheless, their attitudes do reveal certain common properties. First of all, the authorities always kept an eye on the extent to which the reorganization would affect their ability to control the enterprises. An authority has a wide range of responsibilities, the importance of which changes over time. Their chances of fulfilling these responsibilities are changed—in their opinion, mostly worsened—by the reorganization.

Under the unfavourable economic conditions of the early 1980s, the authorities formed the opinion that a lesser number of enterprises would make it easier to accomplish the tasks centrally qualified as the most important ones. Namely, for technical reasons, their management and organizational activities would come up against more obstacles following a reorganization. Several small producers, perhaps of the same line, cannot be made responsible for supply in the same way as before. As for management techniques, it is easier to organize imports, exports accounted in convertible currencies, and contractual deliveries to the socialist countries within the old organizational framework.

The authorities were influenced also by other factors. In their opinion, decentralization could not ease troubles of cooperation, as the already functioning, small independent enterprises are end-product-oriented themselves, and are thus not interested in being subcontractors or suppliers. Thus, independence may cause a deterioration of cooperation, because the former relations of subordination within the enterprise are transformed into contractual inter-enterprise relations; long-lasting relations may now be broken, and conditions are made less favourable for either the seller, or the buyer.

Yet another consideration of the authorities: in the life of an enterprise that has been functioning for many years, problems arising are likely to be less unexpected than in a newly established enterprise, as the former has a long established system of relations, organization, and functioning routines. Also, the authorities are acquainted with their troubles, which is also important. All this confirmed these authorities' reluctance to create independent enterprises, as the decentralization involved risks not only for the enterprises, but for them, too—the extent of which could not be known before-hand.

The uncertainties surrounding the economic results of the reorganization, the fear from increasing difficulties in inter-enterprise cooperation, and the technical aspects of control were all realistic factors which caused the authorities to act prudently in an increasingly difficult economic situation. They judged that the transformation of the existing enterprise ties would make their own, as well as their enterprises' situation, more difficult. Yet this had to be avoided in a situation in which the operational conditions of enterprises had already grown more unfavourable, because of the problems of the national economy.

The considerations set forth above speak for an unchanged organizational framework, and have obviously not been shaped by the requirements of profitable production activities and market adjustment, but by the need to keep enterprises under control, and to reduce the effects of shortages.

Besides the central authorities (the branch ministries), the financial apparatus played a determinant role in the reorganizations. In establishing their positions, the Ministry of Finance—of the authorities, the strongest supporter of the reorganization—and also the National Bank of Hungary had to consider contrary requirements.

The attitude of the Ministry of Finance towards reorganization is more complex than that of the other authorities. In 1980, when reorganization began, it did not wish to grant budgetary subsidies to the reorganized enterprises. It soon had to make concessions, however, as it became evident that preferences and subsidies were vital for the creation of financial conditions for the functioning of the new enterprises. Thus, giving up its original position, the Ministry of Finance introduced a few financial facilities with the explicit purpose of supporting reorganization, and improving the economic position of new enterprises. Therefore, with a view to promoting reorganization, the Ministry of Finance had to check its ambition to the effect that this process should start, if possible, without additional budgetary expenses.

The position of the National Bank of Hungary in relation to the reorganization was in many cases rather ambiguous. In the course of putting into effect the reorganization and establishing the general financial conditions, it directed its efforts towards creating the operational conditions needed by the new enterprises. In certain cases, however, it did not act as one of the organizers of the economic macroprocesses, but—following its narrower trade considerations—as an institute interested in repayment of its borrowed money. Thus in general the Bank took a stand for reorganization as a desirable trend of transforming industrial organization, whereas in particular cases it acted against reorganization and for repayments of its borrowed capital.

The main concern of the Ministry of Finance and the Bank was whether the financial burdens and losses of enterprise independence should be borne by the budget or by credits. In fact, there has never been a real alternative, but the Bank more often opposed reorganization with reference to the probable difficulties of credit repayment, than the Ministry of Finance did with reference to an increase in demand for subsidies.

The various authorities thus showed various attitudes towards reorganization. Nevertheless, there are certain basic features in their attitudes which show a similarity. *It was a common feature that in the decisions made on reorganization, the consideration of an improved economy was not of primary importance,* as we could see. *Neither did considerations of strengthening competition between enterprises, improving adjustability, and of increasing exports accounted in convertible currencies play an important role in the decisions.*

The enterprises' interests

Not only the central authorities, but also the other party, i.e. the enterprises themselves were interested in the preservation of the old organizational pattern Under the prevailing system of economic control and management large enterprises acted as partners of the authorities in fulfilling the tasks laid down by the latters. In exchange, the large enterprises were in a position, on account of their weight and prestige, to obtain the preferences deemed necessary for their functioning. The splitting up of large enterprises and trusts would destroy this system of relationships based on mutual interests.

The interests of enterprises to be considered for reorganization are to be discussed separately from those which were beyond this scope. The latter enterprises could be interested, with a view to weakening monopolistic positions, of some of their suppliers or rivals by the organizational decentralization of certain large enterprises and trusts. In each case, reorganization encountered resistance on the part of the affected large enterprises' or trusts' management. They tried in various ways to maintain the large enterprise organization. They used their informal relationships with the authorities in their attempt to avoid reorganization. A different kind of tactic was also resorted to: internal reorganization was effectuated and cooperation shaped within the enterprise in such a way as to present serious obstacles to decentralization.

In contrast to the management of large enterprises and trusts certain factories within the latter did have the ambition to become independent. In recent decades, however, they have not had good chances of breaking away. Were they to submit such proposals, the management of the large enterprise was to give its opinion on it, and it had a number of instruments at its disposal which it could use to obstruct the 'break-away' unit and its managers.

The decision-making process

The changes in power relations also left their mark on the decision-making process of reorganization. Decisions on reorganization were made within the framework of the traditional control system; no change was made in the jurisdiction of the authorities. Thus (before the introduction of the new forms of enterprise management) it was in the branch ministries' authority to determine the organizational framework of their enterprises, in addition to exercising their other proprietary functions. Thus decisions on reorganization were in most cases made by authorities having opposite interests. Yet the government introduced an organ whose legal status was rather ambiguous: the Coordination Committee.* This entered the decision-making process by getting the task to initiate the decentralization of large enterprises, rather than authorities (branch ministries) which have opposite interests. The Coordination Committee—in which financial and planning, as well as party and trade union organizations were represented—was to initiate organizational changes "from the top", to coordinate the elaboration of the rules of procedure, and to evaluate the authorities' proposals concerning the organizational changes.

Yet the Coordination Committee itself was not homogenous in every respect. Nor did its existence guarantee that the organizational changes would in fact be made. It was, namely, not authorized to make decisions, but only to initiate and support

* A detailed analysis of the activities of the Coordination Committee and of the opposing interests embodied in it can be found: [5].

proposals. It was not in a superior position to authorities and thus able to proceed as a summit organ in charge of reorganization. Thus the implementation of reorganization remained an open issue, and it became dependent on the power relations prevailing at the time of the different organizational revisions. That is to say, this kind of decision-making left the outcome of the reorganization undecided from the very beginning.

The position of the Coordination Committee enabled it to help in accelerating the pace of reorganization, but it did not enable it to prevent deceleration of the process. Its existence was no obstacle in the way of either direction becoming prevalent. If it received a strong impulse from the government to promote reorganization, this strengthened its position as against the authorities. Yet the force of its arguments did not come from the weight and nature of the problems raised by the state of industrial organization, but from reference to positions taken on the top level and legitimating its initiatives. This was the situation which could turn the scale in favour of reorganization in the course of the disputes with the central authorities.

This circumstance is also what accounts for the changes in the number of reorganizations. In 1980–1981the first impulse to start decentralization was announced at the top level. After that, the continuous reduction in the number of decentralizations is to be explained by the fact that the central priority given to the matter was not permanent. When, at a later date, the government again took an interest in reorganization, the number of enterprises undergoing decentralization retreated from the 1980–1981 rate. This was because every authority affected, as well as the government, became more cautious with reorganization, facing the difficulties of the interested parties, and the strong resistance. Parallel to this, the position of the authorities, voicing their arguments with increasing force and also referring to real difficulties, gained ground against the Coordination Committee. Their position was further strengthened by the circumstance that the making and implementation of decisions was in their hands. In certain cases the authorities could even circumvent the Coordination Committee in the conciliation process preceding the decision on an organzational question, for they sought a higher-level decision forum from which they could win acceptance of their own standpoint. Their arguments were made stronger by their being able to refer to enterprise problems, interpreted by them, as they—and not the Coordination Committee—had information on the enterprises and on the likely consequences of reorganizations.

Changes in the situation of the reorganized enterprises

If a balance were drawn up of the changes in the situation of the reorganized enterprises, it would produce a rather mixed picture. On the one hand, there would be the improved economic results of some of these enterprises, and the emergence of new efforts to adjust, and on the other hand, the enterprises' basically limited scope of action, and their unchanged dependence on authorities.

The indicators showing the economic results of the reorganized enterprises remained below the average of their field in the old organization. Therefore, in the process of reorganization, the authorities were to provide for the financial conditions of the enterprises' operation, in order that tensions in economic management should not jeopardize smooth production and supply. If the instruments of economic control and management (the taxes and financial regulations) did not prove to be sufficient to achieve this, special preferences were granted so as to maintain the functioning of the enterprises.

Quite a considerable number of the new enterprises improved their economic results. Following reorganization, especially in the first years, their financial results (profits) increased to a much greater extent than the average profit level of the national economy. Sudden improvement in the profitability was generally characteristic of the first year of independence. At the same time, the rate of exports accounted in convertible currencies stagnated or diminished. In the years that followed, the rate of the growth of profit and the improvement of efficiency slowed down, whereas the rate of exports accounted in corvertible currencies started to increase. [6]

Independence prompted the new enterprises to make considerable efforts, as they were left to themselves to face the tasks ahead. The improvement of enterprise performance indicators in the first year of independence proves that most of the new enterprises were able to solve these tasks, so as to produce results in the short run. However, as time passed, the rate of improvement of performance slowed down. When obtaining independence, a series of long outstanding changes and rationalization measures could at once be introduced, to which either no interest was earlier attached or which were not possible to make within the old organizational framework. When these fast mobilizable reserves are exhausted, the rate of improvement of performance cannot be maintained. The challenge was neither strong, nor permanent, and it grew even weaker, as the enterprise stabilized its position.

Rationalization included changes in the product pattern, the finding of new channels of purchase and sales, transformation of the inner organization and system of incentives, and cost-reduction. *These changes may be ascribed to the organizational decentralization.*

In spite of the changes, no such qualities are found in their functioning which would clearly distinguish them from other unchanged enterprises. The reorganized enterprises are working under the same conditions as others. Therefore, the conditions necessary for developing a line of activity guided by profit motives are given, or rather lacking, for them in the same way as for others. Thus it is not possible for an enterprise to widely deviate from the line it followed within the old large organization, nor from the behavioural pattern characteristic of all the other enterprises.

The enterprises which were granted independence could not obtain financial resources for the rationalization of their production pattern—yet this would be necessary from several aspects. Reorganization breaks a series of production and trade relationships which developed within the large organization. Beyond the substitution of these, the transformation of the sphere of activity and of the system of relationships with the environment may also be necessary. That is to say, it may become important to change the line of production by sorting out old capacities and establishing new ones, to place enterprise capital into other organizations, to provide new kinds of services, and to reorganize home and foreign market relationships. With a view to the changes, it would have been important for the regularory and economic management conditions to promote the profitable enterprises. In other words, that it should be worth striving for the reorganization of activities, and that sources be available for all this.

Finally, *the fundamentally unchanged position of the enterprises is manifest in their unchanged dependence on the central economic control and management authorities.* As for their functioning, and fulfilling central priority tasks, the new enterprises are just as dependent on intervention of economic control authorities, as are those that have not been reorganized. Of course, there may be different channels through which an enterprise enters into bargaining with the central organs. The opening up of new interest-asserting channels may enlarge the enterprise's scope for manoeuvring. Yet this does not change the conditions constituting the subject of the bargain. The fundamentally unchanged position of the enterprises goes back to the fundamentally unchanged official procedures affecting the enterprises.

The function of large enterprises within the system of economic control and management

In analysing the relations between reorganization and the system of economic control and management, the question arises: what are the specific qualities of the functions fulfilled by large enterprises within the system? In other words: in which way does decentralization of the large enterprises affect the system of economic control and management, or, what is the relationship of the latter with the enterprise organizational system based on large enterprises?

In addition to other important qualities, one of the determinant features of a system of economic control and management is its way of handling and correcting the unsuccessful actions, deteriorating performance and financial problems of the enterprises. In alleviating financial troubles, the large enterprise organization does play a role, i.e. it redistributes resources among its units. The management of the large enterprise can redistribute investment resources as well as those necessary for wage increases among units. This redistribution partly levels up, and partly differentiates, the various units. As a result, a unit is not left to itself to bear the burden of its inefficient work, as the large enterprise can make corrections, through redistribution of resources, in favour of the units struggling with financial troubles. From this aspect, *the redistribution of resources has an important stabilizing function*. Namely, the large enterprise redistributes resources partly instead of the economic control authorities, and thereby narrows the limits of official interventions.* This is a further basic function of large enterprises, in addition to responsibility for supply and the direct control of enterprises.

The system of economic control and management introduced by the 1968 reform had it in its fundamental construction to delimit central intervention and strengthen enterprise independence. The large enterprise centres cooperate in this with their own activities of capital redistribution. A kind of division of labour develops, namely, between the economic control authorities and the management of large enterprises. In this process redistribution within the enterprise is assigned the role of acting against functional troubles—caused by finances—i.e. in accordance with the principle of strengthening enterprise independence, the enterprise uses its own resources to solve problems.

If there were no large enterprise centre, i.e. no possibility of resource redistribution, enterprises would turn directly to economic control organs with their applications for subsidies. However, this is no different from the everyday phenomenon in the present situation, in which the form of large enterprise organization predominates. Nevertheless, it seems justified to assume that, without large enterprises, and other basic conditions remaining the same, the economic control organs would have a greater amount of, and more minute work in, warding off functional troubles of enterprises. In this sense, *the large enterprise effectuates redistribution partly instead of the economic control authorities, and of course, partly together with them.*

* This reasoning draws on Iván Schweitzer's analysis which is formulated in another context, yet arrives at similar conclusions. About the relations between the enterprise mergers of the 1960s, and the 1968 reform of the economic mechanism, he says that the system of economic control and management relies on the existence, cooperation, and partnership of the large enterprises. According to this, "after the enterprise mergers and relying on national large enterprises and trusts which have obtained an 'overall view' as well as authority in their own field, it is possible even to face a system of economic control and management without plan directives. This is because the large enterprises will use all means to assert national economic interests in their own field. This is the mechanism which is built upon the enterprise's responsibility for supply (in other words: on the state-created monopolistic position)." [7]

Within this system, the advantage of large enterprises over direct central intervention is that the former are better acquainted, as a matter of course, with the nature of their own problems, and further, that they may be more interested and act more responsibly in finding a solution.*

Apart from its levelling or differentiating effect, justly criticized from another aspect, it can be said of the redistribution of resources within the large enterprise that, in the final account, it is in accordance with the established system of economic control and management. Large enterprises fit into the system of economic control and management, because they are better partners of the central authorities than small economic units in fulfilling expectations and tasks formulated within a hierarchically organized economy. Further, they cooperate in fighting functional troubles, replacing some of the authorities' interventions with their own activity. All this makes it clear that enterprise scale is not simply a question of organization. The enterprise size distribution is tightly interrelated with the economic mechanism, i.e. the system of decisions.

Dilemmas of the administrative measures of organizational transformation

The administrative transformation of industrial organization raises a number of questions. For example, does the system of economic control and management get into a new situation as a consequence of the reorganization? One way of thinking about this is that the reduced influence of large enterprises and the increased number of enterprises are themselves a transformation of the earlier situation, inasmuch as they somewhat reduce the direct intervention potential of the economic control authorities. For, if it is not possible any more to control enterprises because of the splitting up of large enterprise organizations, the relation between the greater number of independent, smaller enterprises and the economic control authorities cannot be so close as it was before. This statement would hold upon two conditions. First, organizational decentralization should be ample enough; second, economic control and management should not be seeking ways to maintain enterprise dependence through other channels.

It can be countered that reorganization alone cannot modify the relationship between enterprises and economic control authorities since, other basic conditions being unchanged, the enterprises' scope of manoeuvring does not increase. Thus the reorganization does not lead to any appreciable changes.

* There is no discussion here of the well-known phenomenon which is that the large enterprises do not only replace and thereby delimit central intervention, but at the same time, in other aspects, they need and make use of the cooperation of the economic control organs in diminishing the tensions accompanying their activities, forcing preferences and subsidies from them.

The limited scope of reorganization, and the survival of the large-enterprise-dominated structure are not solely the consequence of the mutual compromises between the various economic control and management authorities. They also express the fact that a fundamentally unchanged system of economic control and management intending to keep enterprises in a position of dependence as in the past, would encounter difficulties in its ambitions. In the case of a significant reduction of the number of large enterprises, there would be no established procedure to prevent the large number of permanent economic troubles of enterprises, or to assert interests qualified as of national economic importance.

Therefore, one of the constraints of the reorganizations is that economic control authorities should not come into a situation in which the methods of controlling and influencing economic processes would prove insufficient. This is to say that *if organizational decentralization is undertaken without carrying on the reform of the economic mechanism, this fact alone presents an obstacle to transformation.* This is one more reason why no essential change is found in the position of enterprises and in their relationships with the economic control authorities.

It is beyond dispute that the new enterprises did rationalize their activities, to a certain excent, at least in the time immediately following the reorganization. The reorganization has, of course, increased the sphere of enterprises whose problems are brought before the authorities. However, the established methods have proved sufficient to handle these problems, so that, from this aspect, organizational changes have not been a real test.

It must be put to the credit of the reorganization that from the aspect of the reforms of the economic mechanism increasingly asserting market norms, it did not spoil the chance of reforms being introduced, as the organizational decentralization processes would themselves make a part of the reform.

However, this is about all that can be said of the reorganization in the positive sense, i.e. as regards its active contribution to the reform process. The entire process has been, namely, a series of state administrative actions, while the selection of the enterprises to be reorganized and the conditions of their functioning were not determined by market criteria. At the most, a few such consequences of the decentralization can be considered in the perspective of a reform (which may be qualified as "by-products"—for example, that the new enterprises have learned to act on their own, and to bear the consequences of their decisions).

The reorganization does not point beyond the framework of the existing system of economic control and management in other aspects, either. The transformations are to be considered as measures of rationalization taken within the given framework. These are, therefore, measures taken with the intention of eliminating the disorders in the system of economic control and management, while they also provide for preserving the system in an unchanged condition.

The limited extent of the changes achieved is instructive not only from the perspective of the reform but from the aspect of the existing practice of economic control and management as well. This series of measures has made a stir, roused interests, rearranged power relations, while the expected beneficial effects have not appeared so far—which may not be surprising, given the full knowledge of the situation. This is, however, no incidental, but peculiar to any partial solution. What is nevertheless remarkable is the shattered security of the large enterprise form of existence—though not because of the practical developments. Changes are beginning to demonstrate—and this is a new phenomenon—that not only mergers, but also decentralizations can be used to fight functional disorders of the economy. The latter measures have so far been dismissed as a possibility for consideration.

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ПРЕОБРАЗОВАНИЕ СТРУКТУРЫ ПРЕДПРИЯТИЙ — БЕЗ СУЩЕСТВЕННЫХ ИЗМЕНЕНИЙ

П. ВИНЦЕ

Статья посвящена изменениям, которые произошли в организационной системе экономики, в частности реорганизации и децентрализации крупных предприятий, трестов. Продолжавшийся несколько десятилетий процесс слияния предприятий сменился организационной децентрализацией и одновременно такими мерами, направление которых совпадает с тем, которое является одним из условий продолжения реформы. В статье анализируются аспекты селекции, определяющие ход реорганизации. Анализ государственно-административных решений в связи с реорганизацией и стоящих за ними столкновений интересов показывает, что для проведения узких изменений система управления экономикой не должна была пока пересмотреть систему своих связей с предприятиями. То есть ослабление жесткости организационной системы предприятий само по себе — при неизменной системе управления экономикой — не расширяет простор для деятельности хозяйственных субъектов и поэтому не вызывает существенных изменений их результатов и способности к приспособлению.

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FAILURE AND RETREAT IN THE HUNGARIAN PRIVATE SMALL-SCALE INDUSTRY

(Data for a revision of government policy towards the small industry in the eighties)

I. R. GÁBOR–T. D. HORVÁTH

It is an important experience of the last five years that, while the total employment in the private small-scale industry continued to increase, this growth still asserted itself practically in the number of the artisans who are not engaged full-time. This stagnation in the employment figures entailed a large-scale exchange among artisans.

Although the rate of this exchange cannot be considered too high by international comparison, the given rate is not self-explanatory in Hungary—knowing the unsatisfied demand of the population and of public agencies for the artisans' activities. The article seeks an explanation for this failure and retreat of unfavourable proportions both according to government agencies and the National Federation of Artisans.

It is an important experience of past years that, while the number of the Hungarian private artisans has shown a further increase, this increase has, in practice, only taken place among those who pursue their trade not as a chief occupation. Besides, this increase, practically a stagnation of numbers, has been concomitant with a high rate of replacement, which is the reason for our research of the subject indicated in the title.

Despite the fact that the rate of replacement is not unusually high in comparison with Western data, in Hungary, where household as well as communal demand for artisans' work is still not satisfied, the given rate of replacement is by no means self-evident. Therefore, we have tried to seek an answer to the question: what is the cause of failure and retreat of an unfavourable high rate, as acknowledged by the opinion of government organs and of the National Federation of Artisans?*

* The investigation was made in 1986. It was commissioned by KIOSZ and organized by the Economists' Small Cooperative 'Economix'. Interviewers were Csaba *Bánfalvy*, Csilla *Gellény*, Csaba *Sasfi* and Lydia *Töttösy-Márkus*. Csilla Gellény contributed to the research project, in addition to interviewing, by helping to compose the data base and drawing up a partial study. We thank them for their devoted and expert cooperation.

Small-scale industry and its development tendencies and fluctuations (1949–1985)

The years following World War II were a period of fast reorganization of private small-scale industry, as well as of fast enrichment for some of the small entrepreneurs.* It ended with the series of restrictive measures instituted from 1949 onwards. As a consequence of these measures, the number of those engaged in small-scale industry—in 1946 amounting to 57 percent of industrial workers—fell by a quarter in 1949, and by 1953 it fell to an eighth of the 1947 rate, i.e. to less than 4 percent of industrial workers.** At the same time, entrepreneurship was totally repressed; it was mainly the elderly tradesmen doing repairs in the traditional manner that were allowed to remain independent.

The drastic measures taken against handicraftsmen were largely due to the open hostility of many small proprietors towards the political programme that aimed to introduce the Soviet model of socialism. Later on, it was the logic of the economic control and management system, based on directive planning, that spoke for liquidation of private small-scale industry and for rallying artisans into cooperatives. One of the restrictive measures of the time—the introduction of central material allocation—was also intended merely to draw the still existing small private industry into the sphere of the directly planned economy.

After 1953, the position of small industry changed according to the then current changes of political struggles.

In 1953 a policy was introduced in which anybody fulfilling lawful conditions could take out a licence and the state granted credits and material to promote small industry, consequently the number of artisans grew to more than double within a year. However, some of the central economic management and local government organs sabotaged implementation of the trade law—first covertly, and later, referring to the danger of capitalistic tendencies strengthening, also overtly.

However, 1957 witnessed yet another upward trend. The economic necessity of private small-scale industry was now recognized for its long-term validity. What is more, so was the eventual necessity for subsidies, in case handicraftsmen carried on activities that complemented the industrial and trading activities of the nationalized sectors.

However, the boom of small industry, that had only just begun, was soon stopped by the central determination to adjust artisans' incomes to the earnings of the workers of state-owned industrial enterprises and by the renewed efforts to make artisans join cooperatives. From 1958 onwards, difficulties of material purchase, prices

* The history of private small-scale industry after 1945 is discussed in detail in [2], [4], [5], [6]. As for its major tendencies and fluctuations, see [3].

** Here and in the following, if no other source is indicated, country-wide data are taken from [9], [10], [13].

pressed low by official regulations, and discrimination (compared with the position of workers of socialist industry) played a part in the year-to-year decrease of the number of artisans, and the output of small industry was also failing.

From the late 1950s up to the mid-1960s no word had been said in the official documents about the efficiency and competitiveness of small industry, and in general, of small-scale production and enterprises; the tone of mass communication media was condemning.

By the mid-1960s it became quite clear that the directive economic control and management system had to be radically reformed, for supply problems had become serious. This led to yet another revision of the policy concerning private small-scale industry. This revision was accelerated by the introduction of the 1968 reform, the differences between positions taken on different levels came to light. In addition, there was evidence of inconsistencies in legal regulation, and extreme differences in the judgement and handling of private small industry between local government organs.

Even though slowly, the number of artisans had been growing smoothly since 1970. This growth was not due, however, to an enlarged practising of trades in the form of full-time jobs, but rather, to taking up a trade in addition to one's regular employment or during retirement.

About the mid-1970s, economic control and management tried to drive small industry towards servicing activities in the first place. For this end, the tax burdens of servicing tradesmen with a yearly gross income below Ft 100 thousand were considerably eased. Besides, those just starting a trade were exempted from taxes.

As a result of the measures brought at the time, private small-scale industry had come out of a dead end. However, the discrimination against goods-producing activities and favouring only services proved to be untenable. At the same time, in the highest income brackets, the concealment of incomes had become increasingly conspicuous, and interests working against the enlargement of business activity were growing.

Although the 1980 resolution of the Central Committee of the Hungarian Socialist Workers' Party laid down that the factors constraining small industrial activities without reason had to be eliminated, the putting into effect of the resolution has made slow progress. The effect of the tax facilities of 1981 granted to commodity producers was neutralized in 1982 by raising the social insurance rate. The last years' rise in the total number of tradesmen is almost exclusively due to the introduction of passenger transport and transport of goods as newly legalized branches of private smaller industry. Within the total number, the rate of trade-practising beside regular employment or during retirement has shown a further increase: those engaged in small industrial activities in full-time employment make up little more than half of the total number of tradesmen (see *Figure 1.*) What is more, the rise in the number of tradesmen is accompanied by an increasing rate of replacement, already reaching 35 percent.

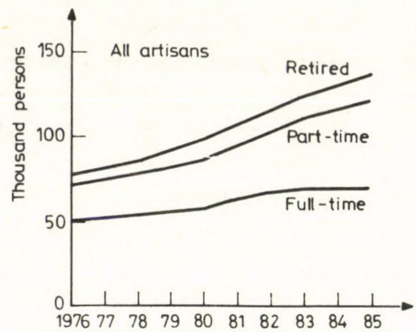

Fig. 1

Distribution of artisans by employment relations

If, finally, the extremely low number of employees per tradesman working full time (about 0.3 percent), their low business concentration (see *Table 1*), and the reluctance on the part of most of the tradesmen to enlarge and modernize their workshop are also taken into consideration, it will be quite clear that much more efficient measures are needed to let the potential of small-scale industry be utilized.*

It is true, though, that several measures have been taken in favour of small industry since 1982. Looking back, however, the statement is to be made that they have not much eased the effective constraints on the development of small-scale industry.

For example, the number of employees allowed for a small-scale industrial workshop has been increased in vain, if—because of the tax consequences—tradesmen

Table 1

Number of artisans working with employees, and number of employees in 1985

Artisans working with employees		Number of artisans working with						
		1	2	3	4	5	6	more than 6
Number	Ratio in percentage of artisans in principal occupation (full-time)	employees						
15333	24.4	9249	3424	1542	630	282	163	43

* On the reluctance of today's small organizations to invest and on how this is related to the entrepreneurial character, see [12].

rarely find it worth employing more than two or three. If the wage tariffs prescribed for small industry were observed, no employees would be found; because of the poor social welfare and labour safety conditions, the wages actually paid in the sphere of small industry amount to two- or threefold of these in the socialist sphere of industry. Those actual wages, however, are impossible to make legal, because of the extremely high taxes. In addition to the above-mentioned constraints, the discriminations against private smaller industry, in the field of supply of materials and means of production, are still functioning.

The effect of the 1984 tax amendments (a lowering of the tax rates) is thwarted by the still prevailing practice of assessment of the tax office. Namely, taxpayers are justly afraid that, if they make investments, the mere fact that "they have got money to invest" will even further raise their assessed income. Finally, in some places the local authorities hinder private industrial activities with informal measures, against which, lacking effective representation of their interests, the artisans are practically defenceless.*

Under such circumstances, with the high rate of fluctuation in small industry, a role must be played by distrust on the part of the tradesmen—which is manifest in their short-term thinking, preparing the way for a fast retreat well in advance. This must also be a contributory of the shrinking sphere of the full-time practice of small industrial activities, to which is added the effect of a taxation system disadvantageous for those engaged in such activities as their full-time job. (That is, a given total income is even officially taxed much less if only a part of it stems from private industrial activity; besides, in the case of pursuing a trade as a secondary occupation, there is less uncertainty of existence owing to assessment of the tax office.)

The phenomenon of failure and retreat as reflected by statistical data

In the following, we shall make a review of the characteristic features of failure and retreat as they appear in the statistical data, relying first on the available nation-wide data, and then with the aid of the tables drawn up on the basis of the KIOSZ (National Federation of Artisans) records of two districts of Budapest (VI and VII).

The nation-wide data on the fluctuations of small industry show that, while the yearly number of those taking out licences can be considered at best as stagnating—taking into consideration also passenger and goods transport—those who withdraw are increasing in number with each year. *(Figure 2)*

* On the problem of the safeguarding of interests of small-scale industry, see [15].

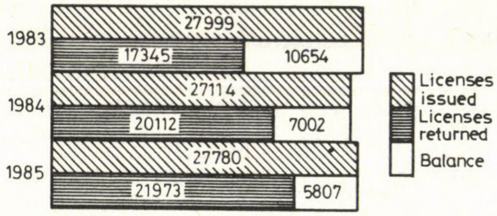

Fig. 2
Changes in artisans' licenses

It is true that, all things considered, the total number of artisans is, though at a decelerating rate, increasing—as is shown by the equations of the Figure. If, however, the effect—temporary, of course—of the relatively new branches of smaller industry (passenger transport and transport of goods) is deduced, a significant reduction is found in the number of full-timers in the last two years. Also, the total number of tradesmen indicates an annual relative decline: in 1985 it amounted to only 25 (see *Table 2*).

Table 2
Changes in the number of artisans

Year	Number of artisans in principal occupation (full-time)	Change in the number of artisans in principal occupation (full-time)	Number of artisans in secondary occupation (part-time)	Change in the number of artisans in secondary occupation (part-time)	Number of artisans on pension	Change in the number of artisans on pension	Number of all artisans	Change in the total number of all artisans
1983	68761	290	36567	3506	13586	1131	118914	4927
1984	65329	–3432	39911	3544	14775	1189	120015	1101
1985	62889	–2440	41362	1451	15789	1014	120040	25

The yearly cases of business failure totals 18 percent (a total of 94 thousand in 1981–85) of the total number of artisans, but this can be qualified as unhealthy not so much in itself, but rather, with reference to the distribution of the causes of liquidations.

Table 3
Distribution of the causes of closing-down of trades in 1985

Cause given for the closing-down	As a percentage of the total number of closing-down	As a percentage of closing-downs due to known cause
Taking up employment in the socialist sector	15	23
Advanced age, sickness, death	11	17
Pensioning	9	13
High taxes and social insurance rates	9	13
Lack of orders	6	10
Family reason	5	8
Official withdrawal of licence	5	8
Entering into a business partnership	1	2
Other causes	4	6
Known causes total	65	100
Unknown causes	35	.
Total	100	.

Although the KIOSZ records of 1985 put down the causes of liquidation in only 65 percent of the cases, it is clear that, contrary to public belief, only a slight number chose (instead of the traditional way of practising a trade) membership in an independent business partnership providing wider prospects for entrepreneurial expansion or increase of the business size. In most cases, the carrying on of a trade ceases for demographical causes, which is the direct consequence of the high rate of elderly people—among them pensioners—engaged in a trade. Another noteworthy factor is the higher rate of those referring to the effect of regulation ("high taxes"), than of those referring to limited demand on the market ("shortage of order")*: the former

Table 4
Fluctuations within private small industries (changes in the forms of occupation) in 1985

Where? / Where from?	Artisans in main occupation (full-time)	Artisans in secondary occupation (part-time)	Artisans beside pension
From artisan in main occupation (full-time)	–	2415	272
From artisan in secondary occupation (part-time)	2381	–	133
From artisan beside pension	32	3	–

* A similar conclusion is drawn in [16], especially on pp. 37–38.

reason was given by 9–13 percent of those leaving, and the latter by only 6–10 percent. However, the real weight of those two groups must be greater, as such must be the real causes behind the cases indicated as taking up work in the socialist sector in 15–23 percent of the cases.

In comparison with the fluctuation taking place among private artisans, the intensity of the changes within small-scale industry—between practising a trade as a principal occupation and as a secondary occupation or beside pension—is relatively slight (see *Table 4*).

Considering the tendency shown by those changes, it may seem as favourable, from the aspect of the composition of small industry, that in 1985 almost 2.5 thousand artisans practising their trade as a secondary occupation switched over to carrying it on in the form of a full-time job. At the same time, however, about the same number of artisans working full time switched over to continuing their trade as a secondary occupation. This circular character of the internal changes of small industry clearly shows the unstable state of private small industry.

In the two districts of the capital city that have been investigated more closely, 2808 artisans worked in 1984: 1654 fulltime, 584 part-time, and 570 beside a pension. The rate of those handing back their licence (19 percent) practically coincides with the nation-wide figure. The distribution of the artisans in various forms of employment is shown in *Table 5*, according to the lengths of time after which they left their trade. (Here, and in the following, the data cover the period from 1.1. 1984 to 30.6. 1985.)

Table 5

Number of turning-in of licences by form of occupation and length of period spent in trade (pc)

Form of occupation	Number of licences returned: within a year	after 1–5 years	after 5 years	Total number of returns
Main occupation (full-time)	39	132	141	312
Secondary occupation (part-time)	34	87	22	143
Beside pension	5	16	67	88
Total	78	235	230	543

The examination of the turning-in of licences according to forms of employment has shown that the artisans practising their trade beside a pension constitute the steadiest group in the sphere of private small-scale industry, and those practising it as a secondary occupation the unsteadiest. These facts relate to both the rate of yearly turning-in of licences, and the lengths of period of practising the trade. Those engaged in their trade full time take the middle position in both respects *(Table 6)*.

Table 6

Form of occupation and turning-in of licences

Form of occupation	Turnings-in as a percentage of the number	less than a year in trade	Turning-in after 1–5 years in trade	more than five years in trade	Total
In principal occupation (full-time)	19	13	42	45	100
In secondary occupation (part-time)	25	24	61	15	100
Beside pension	15	6	18	76	100
Total	20	14	43	43	100

According to *Table 7,* the differences manifest in the rate of turning-in of licences, and in the lengths of period spent in the trade, are partly due—at least as regards practising their trade full-time and part-time—to differences in the age composition of the various groups of private artisans, and to the divergences in the frequency of turning-in of licences characteristic of each age group. Thus, while the majority of full-timers consists of the middle-aged generation among whom the turning-in of licences is the least frequent, among part-timers the younger generation

Table 7

Age, form of occupation and turning in of licence*

(percent)

Age of artisans	Distribution of the number of artisans		Turning-in of licences as a percentage of the number of artisans		Length of period before turning-in of licences		
	in main occupation (full-time)	in secondary occupation (part-time)	in main occupation (full-time)	in secondary occupation (part-time)	less than a year	one year or more	total
–39 year	41	51	22	32	25	75	100
40–59 years	51	46	9	15	13	87	100
50–year	9	3	56		2	98	100
Total	100	100	19	24	14	86	100

*For lack of data on the age distribution of the artisans of the two districts under examination, the nation-wide data of the first two columns were used as a reference basis.

Table 8

Age composition of private artisans in principal (full-time) occupation, the profitability of their activities, and data of their turnings-in of licence

Age	Turning-in licences in percentage of the number of artisans	Length of period spent in trade before turning-in of licence (total number of turnings-in = 100)		PROFITABILITY				
		less than 5 years	more than 5 years	Low	Low-medium	Medium	Medium-high	High
Young	25	72	28	Heavy industry, engineering industry, building industry, personal services				
Young-middle	11	88	12		precision engineering and telecommunication			
Middle	12	75	25				Metal mass production, building material and chemical industry, woodworking industry	
Middle-elderly	20	42	58	Paper-, printing-, textile industry, textile clothing industry				
Elderly	18	82	18	Leather, fur, and shoe industry, food industry, transporting				
Total	19	55	45					

predominates and their rate of turning-in licences is the highest. It is also clear from the Table that, progressing towards the higher age-groups, there is a decreasing rate for those who turn in their licences without even starting the trade, or leaving it within the space of a year.

All this is not at all to suggest that the differences in the age composition may be considered as the final cause of the differences in the rates of failures and retreats. Namely, age composition is partly a dependent variable itself, expressive of the differences in the market position of the various trades and their forms of practising, as well as of the different conditions for providing the necessary facilities for successful work. This assumption seems to be supported by *Table 8,* in which the indicators of turning-in of licences of the two districts under examination are shown according to five aggregate types of trade, compiled on the basis of age composition. At the same time, the position of the spheres of activities put under the category of a given type of trade in the hierarchy of the various trades and crafts of private smaller industry, set up on the basis of estimated income is also indicated.*

Table 8 suggests that the young and the elderly are gathered in the less demanded trades—more exactly, the former in the open, the latter in traditional trades. However, the middle generation predominates in the trades more in demand (consequently, more profitable). Therefore, the regularities of the differences in the rates of turning-in of licences, and in the lengths of time of practising the trade find their explanation in both the characteristics of the age-group, and the particularities of the various small industrial occupations, influencing (also) the age-composition of those engaged in these occupations. This is clearly confirmed by what was found in the course of our interviews as set forth in the following.

The typical causes and motives of failure and retreat as they emerged in the course of the interviews

Of the 543 artisans turning in their licences during the eighteen months under examination, 150 were selected according to the distributions by length of time spent in the trade, and by form of employment as shown in *Table 5*. Thirty-nine interviews were finally made, after several calls. One of the reasons for the mere 25 percent rate of answers is that many of the addresses given in 1984–85 had changed by the time of the call. The number of interviews was further decreased by refusals to answer. Seeing the first sign of a relatively low percentage of answers, we changed the plan behind the

* The classification was borrowed from study [8].

interviews in that they were now to provide the grounds for a deeper analysis of individual careers and conflicts.

Ten of those interviewed did not even start on their licensed private trade, or had pursued it for less than two years. Seven left their trade within five years, while twenty-two had practised it for periods longer than five years. The latter group was the most co-operative in the interviews.

The interviews showed that in most cases of closing-down—especially in the cases of those practising a trade only for a short period—the underlying cause is the frustration of hopes of becoming a private artisan. Thus the first task is to examine the reports concerning the initial motives for taking out a licence. First of all, financial motives were mentioned, together with family and employment problems.

> "Well, if I have to stay at home and there is nothing else, at least I should like to make some money. My qualification is shorthand-typing, I could not have earned more with that". (knitter in full-time occupation for 11 years) "I wished to complement my low pension, I was staying at home, so I wanted to do something useful." (embroidery pattern printer in principal occupation, did not start the trade) "I became a private artisan so that I could supplement my income, as I have two children... What we had was little, and in this way I could earn some more money." (mechanical instrument maker, in part-time occupation for 3 years)
> "I was fed up with helplessness and shortage of money, something had to be done to earn a decent living." (taxi-driver in part-time occupation for 2 years)

Another cause, less frequent but characteristic—and in many cases set forth with an ardour—is the love of a trade, and thus the hope for more productive and more reasonable work, which is also profitable.

> "In Hungary, innovation is impossible... For example, I sign an agreement with the Martfű Shoe Factory, as I have worked out a new technology... But then I am not allowed to talk to the foreign customers. Martfű will do it. Even if they have received a complete technology, and cannot answer questions of detail... Then, in two or three years, may come forward again with a new technology. Sure I can't go through it all again." (Shoemaker in full-time occupation for 4 years.)

> "For various reasons, we could not work, as we got only about half of the material supply we needed, so we could not hand back to people the instruments in the condition we wished to. This was nothing to do with wages... Therefore, I started my own trade." (electrical mechanic having worked part-time for 16 years)

> "I became a tradesman because I had a job where we had to go to several places, among others, we worked for private tradesmen... They expected that in one or two days after notice, repair should be done. But the enterprise I worked for was not that flexible, so some of us took out a licence and did the job, while keeping our full-time job with the enterprise." (mechanical instrument maker having worked part-time for 3 years)

Finally, in the case of some of the questioned, family tradition seemed to be the major cause of becoming private artisans, decades earlier.

"There were nine sons, and four daughters in the family. The elder children went into the perfume trade." (full-time dental mechanic for 39 years)

"My godmother had been in the knitting trade as far back as 1955, since... originally, she had been a sportswoman and thus could hold a licence." (full-time mechanical knitter for 10 years)

"My way of life is related to the fact that I come from a family of traders." (die-caster having worked full-time for 30 years)

"I carried on the trade of my deceased grandmother." (full-time tailor for 4 years)

Reverting now to the causes and motives of *turning in licences,* there is quite a sharp dividing line between those looking back on more than five years in trade, and those turning in their licence before (the majority long before) such a length of time.

Members of the former group enjoy a basically stable existence. They live where they did when retreating and quite a number of them turned in their licence after thirty or forty years in trade. Among them, failure in the real sense of the work had not occurred. A successful career, or material well-being is not always the case, yet all feel that they are better off now, than they would be, had they been working as employees. The majority have been compelled to retreat simply by age. Some have passed on their trade to family members and are now having a rest, or they continue working, only at a lower pace.

"Well, I spend my time so that I have taken out—what's its name?—a licence to practice, and on and off I'm practising." (dental mechanic, having worked full-time for 39 years)

"Now I don't have an employee, because we've formed a business partnership... I've got my pension: 6700 forints, I can't live on it, at least can't maintain the standards I'm used to. So come on, mates... everybody contributes an amount, we're making a business partnership: laugh together, cry together! If we can do something and earn some money, we distribute it among us, if not, we live on our pension." (mechanical instrument maker having worked full-time for 37 years)

A smaller group of those with a long past in private trade have looked for alternative possibilities of making a living because of the *tax burdens*—apparently unbearable for them.

"I could hardly wait to be sixty! Because, when I raised my turnover, I received a note that I was to pay 150.000 forints. We went and worked like mad, and then came the new notice that I was to pay even more. I could hardly wait to be sixty! It's finished! I don't care what pension I get, I'll get a job besides. But that, I had to get rid of." (full-time mechanic for 28 years)

"I have no more financial resources. All my reserves are exhausted. On the basis of my tax return of 1985, which I back up with bills, I have appealed against the tax imposed on me. And, also, dating from June 1st, 1985, I turned in my licence for knitting... At present, as you can see, I sell the children's wear of my friend in my own shop... I'm thinking about the future. I know I have to do something, but I don't know what, and how." (full-time knitter for 10 years)

"There was a year, in the seventies: 110 thousand, 110 thousand, 110 thousand—it was left unchanged, and then, exactly in this new economic mechanism, from 1980, look, it was raised to 200 thousand!... We did not work for private customers, so not one *fillér* was concealed... the whole thing was a family undertaking." (full-time heat insulator for 27 years)

Compared with the former group, few of those retreating after 1–5 years in trade showed willingness to be interviewed. As the typical term of practising their trade is 1–2 years and as their stories are very similar to those retreating within a year, they will be treated as one group in the following. In this sphere, failure in the real sense of the word is not at all infrequent.

"There was awfully little work, and we did this because we were hard up. We were broke, we'd always been expecting an order for the next day, and finally it did not come, and there it ended, and then we gave up." (homecleaner-parquet-polisher couple having worked full-time for 9 months)

"For a time, all went well with me, as long as I had standing orders from enterprises. Then, competition pressed me down, though it didn't really pay already, but still they underbid me." (house-cleaner having worked full-time for 9 months)

Failure does not equal bankruptcy in this group either, but it does mean the impossibility of carrying on the trade.

"There was a period of six months without any orders, but still I had to pay the tax. However, my lower tax return was not accepted. In the final account, I can't say this is failure, as I could've gone on, though it's a fact that the wrangling with the council got on my nerves and I wanted peace. I felt cost was more than benefit, so I gave up." (part-time mechanic for 2 years)

"I could not get near people who would give standing orders all through the year. We made accounts and found that if I went without work for two days more, we'd have to pay back what I'd earned, social insurance and everything included. One must have capital to get along." (knitwear assembler having worked full-time for 4 months)

"We calculated a certain amount, but the total earnings wouldn't have covered tax, expenses, and material costs. So it was not worth doing. All in all, no profit would'we been made." (candyfloss-maker having worked part-time for a year)

In the cases just quoted, the first sign of a slump led to retreat because the "entrepreneurs" in question had no reserves and thus could not stand up to the fluctuations of business life. For most of them, the solution is to get employment, perhaps maintaining the possibility of trying again, if chances improve. This group consists mainly of young people. Most were active in trades requiring small capital and no qualification (cleaner, toymaker, hand-knitter, knitwear assembler, etc.)

Quick failure frequently occurs also in passenger and goods transport.

"The problem of taxi driving is that there are too many taxis, there is oversupply. Especially in the afternoon, when the part-timers come out, too, as the working hours have ended." (would-be taxi driver, did not start his full-time trade)

"It has no future, if you want to do transporting on your own. You'll be beaten. City Teher* has telephones, all the cars have CB, I can't compete with that." (part-time goods transporter for 2 years)

The interviewed all agree in that three trades: house-cleaning, private taxi-driving, and the clothier's trade (private commerce) are saturated to such an extent, that there competition plays a considerable role in failures. The common factor in these three trades is that no qualifications are required, whereas their capital intensity is different. Thus the scarcity of qualifications does not function as a supply reducer. Characteristically, "real" artisans do not consider those occupations to have any common traits with theirs.

"Private taxi-driving, or cleaning are nothing like a real trade or craft. They are only to make money as fast as possible, and people leave it fast, too. They don't want to do it for a long time." (full-time shoemaker for 38 years)

"The producing industry is one thing, and private trading is another. These are two separate worlds. And we do not like each other." (full-time electric mechanic for 16 years)

Shortage or poor quality of materials, difficulties of purchasing or, if supply is short on the domestic market, importing of machines and equipment, are also frequently heard complaints.

"The existing regulation, which has been the same for a long time, does not allow either the increase of income, or the possibility of purchasing the necessary machines and tools. Without those, we work at high cost, which decreases an already limited demand." (full-time shoemaker for 38 years)

"A considerable part of the patent-fasteners circulated in Hungary come from imports. And it's well known that the import supply in this field is very difficult... Bribing is necessary, so that if something is available at all, I can get it, and as much as I want." (costume ornamentalist having worked full-time for 9 years)

* A driver partnerhip—Ed. Note

Several of the interviewed related that, because of the incalculable changes in the official judgement of private small-scale industry—according to some, because of its probably growing restriction—, they carry on their trade reserving the chance of fast retreat, unwilling to make any greater investment than the necessary minimum.

> "I did not have a great fall, for I was clever enough not to wait for that. Orders are issued, one after the other, each one pulling the reins a little tighter. This is going to be worse. It'll never be let loose again." (part-time transporter for 2 years)

Most of those interviewed indicated irrationally high taxes as the main reason for their retreat.

> "Small industry has no future, because of the unreasonably high taxes. Under such circumstances, young people can't start a trade." (modeller having worked full-time for 38 years)

Many talked heatedly about tax assessment—sometimes reassessment—of authorities as something that makes the private artisans' situation uncertain and defenceless. Some said that a higher degree of security in taxation was by all means necessary, even at the cost of increased taxes.

> "When I appealed against the tax imposed on me, I got the answer that the council and the tax office had no interest in maintaining a trade for a lower amount. In this part of the town, artisans pay such taxes on average, and I have to follow suit. If I accept it, I have a trade, if not, I haven't. I did not think that was either justified or business-like." (milliner in principal occupation for 11 years)

> "Things ought to be made simpler in that the artisans who are unfair should be denounced by the customers, and if the complaints prove right, their licence should be taken away. But, as long as the customers are satisfied, artisans should not be bothered." (part-time modeller for 3 years)

> "The whole system of vouchers is precarious and immoral. It would be much better to find a compromise satisfying both the artisans and the tax office. I know a lot of artisans who would not mind paying taxes if the system of vouchers were free and they know what goes and where, so they wouldn't have to fear. A sounder taxation system would do everybody good. A lot more money could be collected, and I'm sure that small-scale industrial activities could go on in a more balanced and smooth way and also in larger dimensions, if the country needs it. As it is, I don't know who thinks what about this questions." (full-time milliner for 11 years)

> "Even if someone is a clever and good worker, after a time he will think twice before going beyond a certain limit." (full-time mechanic for 28 years)

Finally, many referred to the disadvantageous position of private small industries as compared with state-owned enterprises, and to the lack of representation of their economic interests. There was not one of the interviewed who would not comment in indignation, even heatedly, on the activities of KIOSZ in this field.

"Economic representation of interests does not exist, because the leaders are not elected by us." (electrical mechanic having worked full-time for 16 years)

"I just simply state that no such thing exists as representation of interests. Interests are not protected against anybody. Not against the tax office, not against the office of rates and duties, not against the customers." (full-time milliner for 11 years)

"KIOSZ does nothing... It is not fair that it is made obligatory for all entrepreneurs to join." (transporter having worked beside pension for 2 years)

"I went to KIOSZ to buy the stamp and subscribe to the paper. I have no idea, what they're doing. It's a kind of association for the protection of the common interests of artisans, but what they do in fact, I don't know." (knitwear assembler having worked full-time for 4 months)

"In a worse case, they won't listen to me, or tell me not to have any ideas, but to do my soling and glueing, etc. If there is a conference of the trade, it's still better not to say a word, as there is not a trace of democracy. I've had material losses because of KIOSZ being the organ for safeguarding my interests." (full-time shoemaker for 9 years)

"With those momentary rulings, and authorities, such as KIOSZ, I do not recommend anybody to enter into private trade." (knitter having worked full-time for 9 years)

Summary and conclusions

There are few questions today in which consensus has been reached to such degree as in that concerning the period beginning in 1982, since when the handling of smaller industries—and in general, of small-scale production and enterprise—has allegedly been treated in a more favourable way by the Hungarian government than ever before. Opinions diverge only as regards the dimensions of the changes that have actually taken place due to this policy of greater leniency towards the small-scale industries. There is also discussion as to whether this new tendency is a correction resulting from a revision of outmoded ideological theses, or just an episode that is already nearing its end.

As opposed to the above, our analysis and investigations have demonstrated that while ideological obstacles have vanished* (that may have been in the way of treating private small industries according to reasonable considerations of economics and economic policy), no genuine changes have in fact been made in the policy towards small industries.

* In the dispelling of ideological prejudices against small property and small enterprise an important role was played in the 1970s by the study [7] by András *Hegedüs* and Mária *Márkus*, and in the 1980s by the works of Katalin *Falus-Szikra* (the latest one [1])

Besides, the introduction of private taxi-driving and goods transporting—which are of little importance from the aspect of establishing a small industrial sphere of a more enterprising spirit—and a general liberalization of issuing licences (the latter, justified as it may be, cannot be considered in itself a measure in favour of small industries), no notable developments have taken place these past years.

The raising of the number of employees allowed for a small industrial unit has only loosened a constraint not characteristically effective on the expansion of such units, and as regards the latest revision of taxes, it is surely a fiction. On the one hand, even in principle it can only be appreciated as a belated and partial adjustment to the rise in nominal wages and price levels. These have taken place in the meantime and have, prior to changing the rates, automatically modified the sharing of incomes earned in small industries—to the benefit of the state each year. On the other hand, its actual significance is made doubtful by the extensive practice of official assessments in taxation. Finally, the raising of social insurance contributions has badly struck small industries, especially the lower sections.

Thus, instead of any improvement in the situation of artisans, especially of those practising their trade as a principal occupation, what we are witnessing is a non-reduced dependence on authorities and the survival of discrimination against small industries. We have found no changes in the functioning of the organization for the safeguarding of interests of artisans, either.

Under such circumstances, it is not surprising that, instead of the intended and badly needed growth in the number of private artisans, the total number is further stagnating (apart from the yet increasing number in the above-mentioned new lines) and it is even decreasing, except for the pensioner artisans. Besides, the decrease of artisans practising their trade as a (full-time) principal occupation within the total number, which began in the early 1970s, has lately accelerated.

The functioning of private small industry is marked by the instability and incalculability of its regulations. This is mainly why fluctuation within the small industries—i.e. between practising the trade as a principal or a secondary (full-time or part-time) occupation—is of a circular character, and why the rate of turning-in of licences is high. It cannot be explained by limited demand for the products and services of small industries.

At the same time, the interviews threw light on the segmentation of small industries. It turned out that the door through which a massive inflow into small industry takes place opens to a few occupations and trades of a peripheral position. These are activities in which the prospects of legal expansion are the poorest and which have become so saturated in a short time that they hardly enable, as a role, a decent average living. As against those "dead-ends", in the traditionally smoothly functioning branches of small-scale industry, mostly capital-intensive and requiring skills and demanding well-established relations to assure the necessary conditions, the "sellers' market" has survived.

As opposed to the occupations of a peripheral position which serve as doors of inflow and in which the turning-in of licences mostly indicates failure in business, in most cases of the latter circle those retreat who can financially afford it, after many years in trade. This is further supported by the fact that very few exchange practising a trade as a principal (full-time) occupation for engaging in a business partnership.

After these conclusions, it is justified to ask whether, with a "sellers' market" still prevailing in many of the major branches of small industry, it is at all possible to put into practice the policy favouring small industries—announced with such emphasis in the early 1980s. Should we take the position that out of necessity and for the time being, administrative measures—including taxation—must replace the pressure that the Hungarian market cannot exert—for lack of a hard demand constraint—on private small-scale industry, i.e. on the incomes earned in private small industry?

Logical as such reasoning may be, in our opinion at least two weighty arguments can be brought up against the further continuance of such practice.

First, it would hinder the unfolding of competition and the emergence of a "buyers' market" as the only reasonable strategical objective in the long run, the most likely way to which is the establishment of a special "socialist mixed economy". In other words, the restrictive policy referring to the existing emergency situation (sellers' market) acts towards perpetuating the conditions that made it necessary. The other counter-argument is that, under the given circumstances, restrictions strike hardest the most unstable lower sections of private small industry, contrary to intentions: exactly those who, for lack of sufficient capital, special skills which are easily salable or convertible, and adequate connexions, are the least capable of evading or getting through the restrictions.

Therefore, it seems that there is no other choice in the years to come but to put into practice the declarations made in favour of small industries: namely, to eliminate the conditions of taxation favouring those doing a trade as a secondary occupation as against those practising theirs as a principal occupation, to eliminate the incalculability of taxation, and to eliminate the still prevailing uncertainty of the policy governing small industries.

It follows directly from the above that failure and retreat represent only one of the important phenomena, the deeper analysis of which is indispensable for developing the correct policy to be followed in respect of private small industries. Further, it is equally important to examine in detail the phenomenon of segmentation of private small industries, the obstacles to rising to the ranks of "élite" artisans, the low intensity of horizontal fluctuation between the different branches, and finally, the obstacles to legal expansion, i.e. to the development of a really up-to-date and dynamic sector of small industry and enterprise.*

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* Of the latest relevant works, [11] and [14] are especially valuable contributions.

ПРОВАЛ И СВЕРТЫВАНИЕ В МЕЛКОМ ЧАСТНОМ ПРЕДПРИНИМАТЕЛЬСТВЕ

И. Р. ГАБОР—Т. Д. ХОРВАТ

Важным выводом из опыта последних пяти лет является то, что хотя численность занятых мелкой частнопредпринимательской деятельностю увеличивалась, этот рост практически происходит за счет тех, для кого эта деятельность не основным занятием. С другой стороны, и это явление подтверждает необходимость исследования данной темы, увеличение и стагнация численности в большой степени сопровождалось сменой кадров частных предпринимателей.

Несмотря на то, что пропорции смены кадров нельзя рассматривать как необычно высокие, как об этом свидетельствует опыт западных стран, для Венгрии, где существует большой неудовлетворенный спрос общества и населения на услуги частного предпринимательства, такая степень смены кадров не является естественной. Поэтому авторы ищут ответ, чем объясняется, в том числе и по оценке органов правительства и организации по защите интересов мелких ремесленников, неблагоприятное функционирование и прекращение частнопредпринимательской деятельности.

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INVESTMENT CYCLES: A NEW INTERPRETATION OF AN OLD MODEL

A. SIMONOVITS

The paper discusses a model of investment cycles in a socialist economy. The ratio of net imports (import-export/GDP) depends on investment ratio. The growth of investment entails increasing imports which increase the external tension. In the model, the external tension reduces the investment ratio with a two-year time lag. Using a linear version of the model it is shown that, in choosing a stabilization policy, a compromise must be found between a policy less increasing the external tension but involving strong interference and managing with an explosive instability, and a smoother policy which, however, weighs up the target of handling the external tension to lesser extent.

1. Introduction*

András *Simon* [1] formulated a simple model for *investment cycles of socialist countries*. Neglecting now those refinements which were needed for the econometric verification of the model, we shall study the theoretical core of the original model in a slightly modified form. The model consists of two equations: (i) the net import ratio (relative to the GDP) is an increasing function of the investment ratio (relative to the GDP); and (ii) the investment ratio is a decreasing function of the two-year-lagged net import ratio, (feedback).

It is easy to prove that in a linear, time-invariant specification an investment cycle with a period of four years is obtained, where the *damping rate* is a decreasing function of the strength of the feedback. This observation suggests the anticyclical policy of weakening the feedback. Indeed, in models, where the stationary (or equivalently, the normal) values are *independent* of the strength of the feedback by assumption [2, 3, 4, 5] such a policy seems to be justified.

However, a different framework already used by Kornai-Simonovits [6] is suggested here, where the stationary values depend on the strength of the feedback. This anti-cyclical policy will then be infeasible, because it would further increase the already very large *external tension* (relative foreign trade deficit).

* I am grateful to T. *Bauer*, J. *Bonin*, A. *Bródy*, L. *Halpern*, Zs. *Kapitány*, J. *Kornai*, M. *Lackó*, M. *Marrese*, B. *Martos*, M. *Lovell*, Gy. *Molnár*, A. *Simon* and K. A. *Soós* for helpful discussions on the subject of this research.

In our interpretation the investment cycle is a *compromise* between two conflicting goals: 1. eliminating explosive oscillations and 2. reducing unbearable foreign trade deficits.

Let us emphasize that the present model (like Simon's) neglects the *internal tension* of the investment process, so vividly described by Bauer [7, 8], Kornai [9, 3], and Lackó [4]. This omission is intentional, since the introduction of the distinction between *starts* of the investment projects and the yearly investment *outlays* and the emerging *investment commitment* would have complicated the simple idea of the present paper. In a subsequent publication we shall deal with this omitted issue.

At this point we remark that Bauer very strongly emphasized the *asymmetry* of the socialist cycle. His entire theory suggests that norms *do* depend on feedback. Nevertheless, referring to the cycle-free cases, he wrote: "The *same* tensions are present, only the regular oscillation around the norm disappears." (Emphasis by A. S.) (Bauer [8], p. 422)

The structure of the paper is the following: *Section 2* describes the model, *Section 3* analyzes the stationary and non-stationary paths. *Section 4* contains the reinterpretation of the old model, throwing light on the causes of the investment cycles.

2. Model

This section presents the basic assumptions, the variables and the equations of the model.

2.1 Basic assumptions

A1. There exists a single *homogenous* macroproduct which can be produced, invested, consumed, imported and exported.

A2. Both internal and external *prices* are *exogenous.*

A3. The (external) *tension* of the economy is an increasing function of the ratio of *net import* to the GDP, which ratio in turn is an increasing function of the *investment ratio.*

A4. The *investment ratio* is independent of the expected growth rate of the GDP; it depends on the ratio of *requests for investment* to the GDP and on the *tension* lagged by two years.

A5. The *functions* appearing in the model are *time-invariant* and *linear.*

Remarks. Our basic assumptions are obviously very restrictive. Because of the homogenity assumption (A1.), any difference between investment in construction and investment in machinery is ignored. We similarly neglect the distinction between dollar and rouble markets. The assumptions constant prices (A2.) and unrestricted foreign borrowing lost their validity in the seventies. On the other hand, for earlier times they can be accepted together with A4., which was verified by A. Simon [1]. The issue of the internal tension of the investment process was already mentioned in the Introduction.

*2.2 The variables of the model**

For the sake of simplicity, the argument t will frequently be omitted, lagged variables will be distinguished by subscripts.

Absolute variables

Y = GDP.

I = Investment.

M = Net import (=import minus export).

Quotient variables

In a growing economy it is much simpler and more reasonable to use relative variables than absolute ones. We shall therefore use the following ratios (relative to GDP) in the paper:

i = I/Y = investment ratio,

m = M/Y = net import ratio.

2.3 Equations

Now we shall present our equations.

Net import ratio

(1) $$m = -\mu + \mu_i i, \quad \mu > 0 \quad \mu_i > 1.^{**}$$

Tension

(2) $$n = m - \tilde{m},$$

* The principles of notations are as follows: Absolute variables are denoted by Roman upper case letters, while quotient-variables are denoted correspondingly by Roman lower case letters. Coefficients are time-invariant and are denoted by Greek letters with Roman subscript: e.g. μ_i denotes the effect of i on m. Coefficient without Roman subscript stands for 'constant', e.g. $-\mu$ shows the value of m for i = 0. Note that subscript to a variable refers to time-lag.

** It may be helpful to formulate equation (1) in terms of absolute variables: $M = -\mu Y + \mu_i I$.

where $\tilde{m}$ is the *minimal net import ratio* which is conceivable in the economy. (It is a net import ratio where the external tension is zero. Its value depends on the role of the invisible foreign trade.)

Investment ratio

$$(3) \qquad i = \iota - \iota_n n_{-2}, \qquad \iota_n > 0, \qquad \iota > 0$$

We shall call μ_i the *investment-import surplus multiplier*, ι the *ratio of investment request* and ι_n *the strength of the feedback*.

2.4 Basic equation

We have three equations, but it will be sufficient to consider a fourth one which is obtained by a sequential substitution of (1) into (2) and (3):

$$(4) \qquad n = \nu - \nu_n n_{-2}, \qquad n(-1) \text{ and } n(0) \text{ are given,}$$

where $\nu = -\mu + \mu_i \iota - \tilde{m}$ and $\nu_n = -\mu_i \iota_n$.

Equation (4) will be called *basic equation*.

Lemma a) *The basic equation (4) has a unique solution for any initial value* n(−1), n(0). b) *Any solution of (4) determines a solution of (1)—(3) by substituting* n *into (3) and (1)*. c) *The n-component of any solution of (1)–(3) is a solution of (4).*

Remarks 1. The *Lemma* shows the equivalence of the original system (1)–(3) to that of (4).

2. Equation (4) is a second order linear difference equation which can be reduced to a first order linear difference equation by splitting the analysis into dynamics of even and odd years. In this way we end up with an equation which is quite similar to that of the well-known cob-web model. In the next Section we shall simply recapitulate (without proofs) the basic properties of such an equation.

3. Stationary path and cycles

This *Section* analyzes the model introduced in *Section 2*. First the stationary path of the basic equation will be studied; second we shall investigate the non-stationary paths with a special emphasis on the cycles.

3.1 Stationary path

Definition. The *stationary path* of the basic equation is a point $\bar{n}$ which the system never leaves if it stayed there for two subsequent years:

(5) If $n(-1) = \bar{n}$, $n(0) = \bar{n}$ then $n(t) = \bar{n}$ for every $t \geqq 1$.

Less formally, the stationary path is the "equilibrium" or the rest point of the system.

In our simple model the existence and the uniqueness of the stationary path is evident; moreover, its dependence on the system's parameters is very simple.

Theorem 1. The stationary path of (4) exists, is unique and given by the following formula:

(6) $$\bar{n} = \frac{v}{1 + v_n}$$

Remark: Since $v_n > 0$, the denominator of $\bar{n}$ is always positive, therefore $\bar{n}$ is always well-defined. The positivity of the numerator is a central issue of the paper but it will be studied later.

We record the stationary value of i: $\bar{i} = \dfrac{\bar{m} + \mu}{\mu_i}$, $\bar{m} = \bar{n} - \tilde{m}$

3.2 Non-stationary paths

Having found the stationary path we can now turn to determine the non-stationary paths. As is known, in this process it will be helpful to introduce the *deviation* of the actual tension from the stationary tensions:

(7) $$\hat{n} = n - \bar{n}.$$

Having substituted (7) into (4), our basic equation reduces to the much simpler equation

(8) $$\hat{n} = -v_n \hat{n}_{-2}, \qquad \hat{n}(-1),\ \hat{n}(0) \text{ are given.}$$

Returning to the equation (3), one can write it in the following form:

(9) $$\hat{i} = -\iota_n \hat{n}_{-2}, \quad \text{where} \quad \hat{i} = i - \bar{i}.$$

(8) and (9) together imply

(10) $$\hat{i} = -v_n \hat{i}_{-2}.$$

From (10) it can be seen that $\hat{\imath}(t)$ *oscillates*, i.e. it changes its sign in every second year.

Following the traditions, years with positive deviations in investment ratio (i.e. with $\hat{\imath}>0$) will be referred to as years of *upswing;* and years with negative (and zero) deviations in investment ratio (i.e. with $\hat{\imath} \leqq 0$) as years of *downswing*. Thus our previous observation can be phrased as follows: two years of upswing are followed by two years of downswing, etc.

As has already been said, there is no relation between odd and even year in our model. Therefore, the ratio of deviations of two subsequent odd or even years will be used to characterize the dynamics of the system. As can be seen from (8), the above ratio is independent of time (and parity), its square root is the *damping rate*. The following Theorem can be proven:

Theorem 2. The oscillations of (4) are a) damped, if $v_n < 1$, b) explosive if $v_n > 1$, and c) stationary, if $v_n = 1$. The period of every oscillation equals four years.

Remarks 1. It is evident that a) damped oscillations are *stable*, b) explosive oscillations are *unstable* and c) stationary oscillations are *Lyapunov-stable*. Furthermore, if $v_n = 1$, we shall speak of *strictly cyclical* oscillations; if $v_n \cong 1$, then the appropriate adjective will be *weakly cyclical* or simply, *cyclical*.

2. As is well-known from the literature on business cycles, any linear and deterministic theory of the cycle is a poor theory, which can only be improved a) either by assuming that the linear system is *stable* but *random* shocks make it cyclical [10] or b) by assuming that the linear system is *unstable* but upper and lower *bounds* constrain the system, making it cyclical. [11]

Both solutions are too sophisticated for us. We retain the admittedly poor theory keeping in mind that systems with slowly increasing or decreasing amplitudes (i.e. where $v_n \cong 1$) hardly differ from the strictly cyclical ones, at least in the shorter run. In the longer run the approximation would break down, but the parameters also vary, which limits the validity of our time-invariant model.

4. A new interpretation of an old model

Having recapitulated Simon's [1] model, we are ready to reinterpret the old model.

4.1 The positivity of the tension

Bauer [8] has devoted many pages to contrast the *symmetry* of oscillations around a stationary value to the *asymmetry* of the cycle, i.e. tension is always positive and, consequently, the actual investment ratio is always lower than the requests ratio:

(11) $\quad n > 0$ and $i < \iota$.

First we shall give a simple *necessary* condition for (11): the tension generated by the requests ratio is positive:

(12) $\quad \nu > 0$.

Remark. In fact the above tension is not only positive but is infeasible. Our condition is a simplest mathematical formulation of J. Kornai's concept of *investment hunger*.

The see the necessity of condition (12) subsitute $n_{-2}=0$ into (4): $n=\nu$, which should be positive.

Condition (12) is not sufficient, since too large initial tensions may result in negative tensions.

Under condition (12) the following theorem is true:

Theorem 3.a) If (12) holds, then the stationary tension is positive for any feedback. b) Moreover, the stationary tension is a decreasing function of the strength of the feedback:

(13) $\quad \bar{n}>0$ *and* $\bar{n}(\iota_n)$ *is a decreasing function.*

Remarks. 1. Note that $i=\iota$ for $\iota_n=0$. Thus Theorem 3 can be formulated as follows: if the stationary tension is positive with no feedback, it is also positive in the presence of any feedback.

2. *Theorem 3* highlights a basic function of the strength of the feedback: to diminish the huge tension generated by the ratio of requests quite a strong feedback is needed.

4.2 Reducing tensions vs. stabilization

Following the argument of Subsection 4.1, one could recommend a radical measure to reduce the tensions significantly: to increase the strength of the feedback. However, taking into account $\nu_n=\mu_i\iota_n$ and Theorem 2, it is easily seen that there is an upper bound on the strength of the feedback, given by stability or strict cyclicity; namely, $\nu_n \leqq 1$. Equivalently, $\iota_n \leqq 1/\mu_i$. Since μ_i, the investment-net import multiplier, is a rather steady quantity, our upper bound seems to be rather inflexible. We conjecture that to avoid explosive oscillations quite a weak feedback is needed. Comparing the requirements of tension-reduction and of stabilization, one can see that they are contradictory. A good compromise can be achieved if feedback is weak enough to avoid quickly explosive oscillations but strong enough to eliminate unbearable tensions.

The positivity of the stationary rate of investment

We have not yet proved the positivity of the stationary rate of investment. For this proof we shall need the following concept: Let $\tilde{\imath}$ be the *tension-free* investment ratio, i.e. that ratio at which there is no tension:

$$(14) \qquad \tilde{m} = -\mu + \mu_i \tilde{\imath}, \qquad \text{i.e.} \qquad \tilde{\imath} = (\tilde{m} + \mu)/\mu_i.$$

Assume that the tension-free investment ratio is positive:

$$(15) \qquad \tilde{\imath} > 0, \qquad \text{i.e.} \qquad \tilde{m} > -\mu.$$

Comparing (14) and $\bar{\imath} = (\bar{m} - \mu)/\mu_i$, and taking account of (2), one obtains

$$(16) \qquad \bar{\imath} = \tilde{\imath} + \frac{\bar{n}}{\mu_i}.$$

The positivity of $\tilde{\imath}$ and $\bar{n}$ implies $\bar{\imath} > 0$.

Moreover, (14) implies that $\bar{\imath}$ is also a decreasing function of the strength of the feedback.

Finally we mention an equivalent form of (12): $\tilde{\imath} < \iota$, *i.e. the tension-free investment ratio is less than the request ratio.*

Positivity of non-stationary variables

After having determined the necessary condition for the positivity of the tension, we almost forgot about the positivity of the non-stationary variables. Rather than presenting exact conditions here we shall be satisfied with the following remark: *If the stationary variables are positive and if the system is stable, then a system starting from tensions close enough to the stationary pair of tensions will only have positive variables.*

4.3 On the control by norm

Until now we have avoided the usage of the expressions *norm* and *control by norm*, (cf. [2]). Nevertheless, equation (9) can be interpreted as control by norm and the stationary values as norms.

Call $\bar{\imath}$ and $\bar{n}$ *the normal rate of investment* and *normal tension*, respectively. Then (9) describes a situation called control by norms: if the actual tension is lower (higher) than normal, then the actual rate of investment will be higher (lower) than normal in two years.

Note that (3) and (9) are equivalent to each other if the parameters of the system are fixed. It does not matter whether the original parameters determine the stationary values (norms); or the norms and μ_i, ι_n determine $-\mu$, ι.

However, if certain parameters like ι_n are allowed to vary, then the equivalence of the two approaches breaks down. Staying with our example, if the ratio of request is fixed, then the norms will change; if the norms are fixed, then the ratio of request will change.

Which approach is to be chosen? In our opinion, the first approach (cf. also Kornai-Simonovits [6]) is preferable to the second. Its advantage is not confined to the above discussed qualitative explanation of the cycle. Another advantage of the new approach is its asymmetry. It was precisely the apparent absence of asymmetry of the control by norm that led Bauer to limit the validity of control by norm to the *lower turning point* of the cycle and postulate a non-linear control mechanism for the upper turning point. Once the model is reinterpreted, linear negative feedback becomes acceptable for the entire cycle.

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ЦИКЛ КАПИТАЛБНЫХ ВЛОЖЕНИЙ

А. ШИМОНОВИЧ

В статье рассматривается одна из моделей циклов капитальных вложений социалистической экономики. Доля чистого импорта (импорт минус экспорт) национального дохода (или GDP) зависит от доли капитальных вложений. Увеличение капитальных влажений сопровождается ростом импорта, что вызывает рост внешней напряженности. Напряженность в модели с лагом в два года снижает долю капитальных вложений. Исследуя модель, автор показывает, что при выборе политики стабилизации следует найти компромисс между целями политики, 1. драматично унижающаей напряжённость но доступающей неустойчивость или 2. политики скромно унижающей напряжённость, но достигающей устойчивость.

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OBITUARY

IN MEMORIAM NICHOLAS KALDOR

G. OBLATH

Sometime at the turn of the 1970s and 1980s *The Economist,* which certainly cannot be considered as a protagonist of any leftist Keynesian approach, in a review of a then recently published volume of his collected papers wrote: Nicholas *Kaldor* is the greatest living economist who has not been awarded the Nobel prize of economics yet. *The Economist* was not alone with its opinion but Nicholas Kaldor, born in Budapest in 1908, later settled in England, the best known and perhaps the most impressive representative of the leftist wing of Keynesian economics, died on the lst of October 1986 without getting the Nobel Prize—that would have been due to him not only according to *The Economist.*

In Budapest Nicholas Kaldor was a pupil of the famous Model Grammar School together with many other future well-known scientists. He began his higher studies at the University of Berlin and completed them at the London School of Economics. He then continued his work in England. As an economist he won high international reputation. His Hungarian relations had been nevertheless maintained. In 1946 together with Thomas *Balogh* he was invited by the Hungarian Social Democratic Party to cooperate in drafting the party's 3-year plan. A long pause followed until he again made several visits to Hungary during the 1970s and 1980s as a guest of conferences of the discipline and he was also elected honorary member of the Hungarian Academy of Sciences.

The eighties were surely not the golden years of the economic thinking represented, and the economic political line advocated by Kaldor. This decade brought about the dominance of the monetarist theory and of economic policies based on it, and Kaldor, if anyone, did not welcome that development. He regarded it as "a symptom of intellectual decadence that so many people should accept (the new monetarism) without having the least notion of how the monetary authorities regulate the «money supply»". [1]

Kaldor was one of the hardest critics of this line of economics and economic policies evolving in the Western countries in the second half of the 1970s. Considering that he was one of the most recognized representatives of the once dominating, but lately relegated, Keynesian theory and that he was an active consultant to governments trying to implement the practical consequences of that theory, this was quite natural.

Above all, however, Kaldor was a theorist. He created lasting values in a multitude of the fields of economics. The theory of growth, the theory of taxation, the economic theory of developing countries, the theory of equilibrium and disequilibrium belong to fields to which he made significant and often quoted contributions. The above list is far from being complete and no mention has yet been made of the multifarious subjects of his publications in applied economics. A scientist, a consultant on economic policy and director of national and international organizations, Kaldor also was a teacher—he considered this one of his most useful activities—and made generations of economists acquinted with a kind of economic thinking which is both clear, logical and relevant. Over and above that he was a science organizer—the "New Cambridge" school is inseparable from his name.

The generations to come will profit from his achievements in the field of economic theory which Kaldor himself regarded as his most fertile preoccupation. It is apparent from the incomplete list of the array of his theoretical papers that economists familiar rather with the theories of growth, taxation or equilibrium would emphasize other points. In this obituary I cannot undertake a comprehensive survey of Kaldor's *oeuvre*. I should only like to highlight some lines of his way of thinking. I nevertheless hope that the problems I wish to point out from the treasury of Kaldor's theoretical work are important not only for me but will also meet the interest of the readers of this periodical.

The theoretical and economic political statements of Nicholas Kaldor are appreciated in East and West as such that either set out from or arrive at the conclusion that markets do not function adequately and efficiently and thus their effects have to be restricted. Several of his practical recommendations were undoubtedly aimed at limiting forces of the market, thus at enhanced governmental or interstate control of international trade. It is similarly beyond doubt that such ideas—originating from Cambridge—were backed up by his name and high reputation as promoting the recovery of the aging British economy by protecting it from external competition and by import substitution. Such ideas were duly criticized by many. Perhaps the criticism of Charles *Kindleberger* was the wittiest, arguing that an aging economy is not like an old man. An old man may be asked to retire but this is not the case with a national economy. "The alternative to Kaldor's protection . . . is evidently adaptation". [2]

I have purposely started the appraisal of the work of Nicholas Kaldor with recalling the above controversial policy proposal irrevocably connected with his name. Having again read his theoretic papers about world economic problems and international economic relations I have, namely, failed to understand actually how could practical recommendations advocating strict protectionism derive from his theoretical work. In fact in the conclusion of a paper published in 1977 on economic policy, and addressed also to statesmen of developing countries, the conclusion he drew from failures in Britain was the following: "The secret of successful industrialization thus appears to be an «outward strategy»—to develop the ability to compete in export markets... and to keep the growth of export capacity in line with the growth of industrial activities." [3]

In his theoretical writings in the 1970s he tried to understand and explain those phenomena of the real world which were unmanageable in the frameworks and with the tools of general equilibrium theory. Stagflation was a symptom of that kind and Kaldor had given its first theoretical explanation even before it was called by that name. The explanation he gave was the work of an unusually extensive thinker, a master of economic theory and practice. His explanation may be challenged but it is a revealing fact that the theory of *Olson* [4] hat became popular in the mid-1980s arrived at the same conclusion in this respect as the fundamental paper of Kaldor, published in 1976. [5]

As against the extremely bloodless general equilibrium models which failed in many respects in the light of stagflation, Kaldor worked on building a model accentuating the diverging behaviour and functioning of the various sectors of world economy and of the markets belonging to those sectors. He did not argue (nor did he suggest) that the markets "do not work" but he stated that the markets of unprocessed products (primary energy, raw materials) show completely different regularities and operate in different ways than the markets of manufactured products. Prices are formed in the two kinds of markets by different factors and Kaldor assumed that, as a consequence, any significant change *in any direction* of the price of unprocessed products would depress the demand for and the production of manufactures. In 1987, after the stage of stagflation, the power of Kaldor's theory seems to be confirmed by the circumstance that the general economic boom expected from the decrease of the world market price of crude oil unfolds rather reluctantly.

Studying his writings one gets the impression of Kaldor that he was not an "opponent of the market" but a theorist trying to understand and distinguish the functioning of markets, who was challenged and was prompted to research by the alien-to-life nature of the neoclassic vision of general equilibrium.

Many of his papers dealt with the theory of equilibrium as well as with the causes he assumed to have invalidated this theory and made it unsuitable for handling practical problems. He considered the neglect of the "principle of cumulative causation" [6] attached also to *Myrdal*'s name to be one of the causes, namely, ignoring the fact that the real economies might not pursue states of equilibrium but—whether due to the decisions and expectations of the actors or quite independent of that—they might move away and still farther away from the states regarded by the static theory as equilibrium. Drifting away from the equilibrium may be of favourable direction (which is the virtuous circle), but it may be harmful and increasingly detrimental (which is the ominous vicious circle). These processes may be started and sustained by market as well as non-market (consequent upon government intervention) impacts.

It seems to be an incontestable thesis of Kaldor that the time and the way of interference with market processes should be chosen so as to result in stopping the disadvantageous downward spiral and to let the upward vortex get started—the latter still moved by market forces. However, Kaldor never claimed that the "virtuous circle" was maintained precisely by the array of interventions by authorities. On the contrary: he also attributed the cumulative impacts of "good direction" to the market. In the early 1970s he was trying to make policy-makers understand that there exist economic instruments conforming to the market, such as devaluation of the currency, which are suitable to open the way for cumulative processes of favourable direction, provided that the other instruments of economic policy are operated in a concerted way. [7]

Later Kaldor definitely withdrew his confidence from devaluation, [8] and then returned to his earlier idea [9] to finally arrive at a more balanced opinion in one of his latest papers: "if exchange rate adjustments go far enough, and last long enough, the day will come when they will begin to show results in terms of a trade-loss due to overvaluation and trade-gain due to undervaluation."

Although he held that the kind of a vision of the perfect functioning of markets appearing in some models of general equilibrium theory were irrelevant and not suitable for understanding the real processes, [11] [12] Kaldor repeatedly, and in some papers most definitely, claimed that the forces regulating markets or, more generally, the interactions between people, the actors of the economy, are effective and active.

The idea I should like to quote now to support this thesis was expounded by him in arguing with the views of another great theoretical economist of our times. The mere circumstance does not appear to be particularly interesting, but if we learn that the ideas argued were those of Milton *Friedman,* one of the most notable spokesmen for the effectiveness of market forces, we may have an idea how the circumstances and the motives lent some irony and even piquancy to Kaldor's statement. The theory of Friedman—assuming the stability of the velocity of money circulation—was challenged by Nicolas Kaldor arguing that even if monetary authorities were inclined, let alone able, to powerfully restrict the supply of money, the people (the actors of the economy) would help themselves and invent money. For example, the authorities could not prevent the Christmas buying spree by limiting the supply of money. However drastic the limitation may be, "there would be a chaos for a few days, but soon all kinds of money substitutes would spring up: credit cards, promissory notes, etc... Any firm with a high reputation...could issue such a paper, and would get things on «credit»." [13] Such papers would be accepted by others and a parallel banking system would sooner or later develop. I will not quote more of this train of thought. That much is enough to show Kaldor's serious belief that people and business organizations are able to organize and mutually manage profitable business activities—even against the intervention of authorities.

Kaldor was a so-called verbal economist. Only long ago, seldom, and when it was absolutely necessary, did he rely on the instruments of mathematical economics. A self-derisory reflexion of his made in a lecture of 1985 paying tribute to John *Hicks* gave the reason: that, unlike Hicks, he had never had enough patience to study mathematics. [14]

If this was a disadvantage, then Kaldor could turn it to his and the readers' advantage. Few economic theorists writing in English could present problems of economics in such clear, distinct and fine style. Hungarian economists, too, could learn much from him with respect to style, logical rigour and discipline. A selection of the works of Kaldor will be published in Hungary, paying tribute to his memory. Even though the publication is somewhat belated, present and new generations of Hungarian economists will greatly benefit from reading the works of Kaldor also in Hungarian.

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BOOK REVIEWS

FALUS-SZIKRA, K.: *A kistulajdon helyzete és jövője* (The present and future of small property). Közgazdasági és Jogi Könyvkiadó, Budapest 1986. 264 p.

"In Marxist ideology it is of the highest importance to prove that unearned income from property is gravely unjust, as well as economically indefensible, and that it has to be abolished"— Katalin Falus-Szikra says in reference to the "let it be" approach, in the closing chapter of her book. After an informative and thought-provoking presentation and discussion of facts, she confronts this, in all clearness, with the contexts of reality. Certain types of labour income, being over subsistence level, necessarily lead to property formation, i.e. to the development of differentiated individual property— even within the framework of a socialist economy. Where "there is property, there is usually income, too", since ". . .income from property is the natural consequence of property."

In its undertaking of a systematical representation of the Hungarian experience in the development, functioning, and conflicts of small property, the book makes the way *from income through property to personal property and income from property*. It demonstrates that at certain levels of economic development the consumption structure is bound to shift toward higher-class goods. Consumer durables, including home ownership and holiday house property, although requiring substantial financial means, are gaining importance in people's life. Also, these have not only a use-value, but they are also value-preserving, and can even bring income. The rise in the prices of such goods is usually higher than that of the consumer price level and, in certain forms, they can be used for getting income. The author points out that several circumstances work together to strengthen the income-providing role of material wealth. As interest rates paid by the National Savings Bank do not even reach the rate of inflation, money saving is no good even for value preservation. Other ways of making a profitable use of capital accumulated by private individuals are strongly limited. The sleeping partner arrangement, for example, is prohibited by legal regulations and the introduction of bonds that can be bought by private individuals is as yet of marginal importance only. That is why art collecting and real estate purchasing—activities aimed primarily at value preservation and increase—have grown; and a positive feedback process has developed: increased demand gives impulse to price increases on the markets of works of art and real estate, which gives a further impulse for free monetary resources to turn towards art and real estate property.

The facts and causes of further distortions of the housing market are also analyzed. The rents of state-owned dwellings—still so low that they do not cover even maintenance—and the housing shortage have led to a situation in which the tenant status itself, to use the author's expression, becomes a quasi-property, being saleable and buyable. This quasi-property has thus a market price, the increase of which also surpasses that of the consumer price level. Therefore, this quasi-property also enables those disposing of it (the tenant enjoying a monopolistic position, and the civil servants handling state-owned housed) to get additional income (partly by corruption).

Also a few important aspects—related to the subject of the book—of long-term home building (and purchasing) credits are examined in the book. The old ideal, according to which it is the task of society (i.e. of the state) to provide housing for young families, has proved to be irrational and untenable. At the same time, under the given price and wage conditions, the incomes earned through work in the large socialist organisations are not enough, or hardly enough, to acquire a home. Even the use of a long-term credit granted at extremely favourable terms, at an intreset rate far below price rises (i.e. a negative rate), allows young families to build their own home only at the cost of huge efforts combined with the help of parents. What is more, the favours are often used—often accumulated—by families who do not need them, and whose property ought not to be further increased through favourable credits and other contributions as a gift from the state. The assertion of social welfare considerations must be separated from opening the way for economic processes to function autonomously. Price and wage conditions should be regulated in such a way that, also taking into account social welfare favours and allocations directed at individuals and families, wages should be sufficient to finance the acquisition of a dwelling.

Other sources of accumulation of individual property, not based on work, are also discussed in turn. It is pointed out that the differentiation of individual property is further enchanced by donation and inheritance from one generation to the next. This is in sharp contrast to the socialist ideals, as it strengthens the inequality of chances among members of the young generation. Within the time horizon given to our generation, the conflict that has come about between any rational form of economy and our social ideals must be considered inevitable. At the same time, as the author stresses, we have to look this fact in the face and try, by various means (tax on legacy and donation duty, etc.), to subdue its effects.

During the last 10–15 years, small-scale producing and servicing activities have been growing in the majority of the socialist countries, and the resources of these activities have increasingly become private property; in the book's terminology: small property attached to production conditions. The process has been especially spectacular in Hungary. Beside the surviving legal and illegal small (handicraft) industry, it was in agriculture that small-scale production first started to increase, and parallel with it, its stock of instruments (in private ownership and created by work) came to be established. Later on, under the wings of the large-scale agricultural organizations, so-called subsidiary (complementary) workshops sprang up, only marginally—if at all—connected with agricultural activities. The contractual form of operation spread mainly in the catering industry. Finally, from 1982 ownwards, many small producing and servicing units have been established in the new forms of small enterprise. In the second part of the book this latter sector, and the small industrial (mainly artisan) one are examined in detail. The forms of small enterprise in use in Hungary, and the functioning problems of the small property they utilize, are treated in turn.

As for the small property connected with the production conditions, it is fully justified to reach back to the theorem which says that the nature of the forces of production and the forms of ownership must correspond. It is justly pointed out that, as opposed to the expectations of Marx and of later Marxists, an overall transformation into large-scale enterprises has not taken place in the producing (servicing) activities. The development of the forces of production has left ample room for small-scale economic organizations (incl. those based on family work). It may be added that the economic and technical progress of the last 10–15 years has further increased the viability of small enterprises. This is also supported by data: taking into consideration the industrial and servicing sectors of the advanced countries, the weight of the small and medium units has also been growing in them lately.

One must agree with the authoress: the last 8–10 years' fast growth of small-scale activities in the Hungarian economy has been a move in the correct direction. At the same time, it is justly pointed out that, still, "...the weight of small enterprises in Hungary is much lower than in the capitalist countries of similar development level." The regulation of small enterprises (their taxation included) is highly changeable, their credit sources and capacities for acquiring means of production are strongly limited, and their official social status is still uncertain. Therefore, in respect of capacity utilization and field of activity, they work under economically unjustified narrow limits and self-restriction. In this sector of the economy, investment of private capital is strongly limited and, the existence of many small units notwithstanding, competition is poor. In a feeling of temporariness, small property holders make little effort to establish any long-term good reputation of their enterprises. All this works towards a situation that a far too big part of the income of the small units will be individual income, the consequence of which is the relatively high individual consumption in these circles.

The authoress is right in stressing that it is necessary to give an impulse to small enterprise activities. At the same time, she establishes: "... small property does not and cannot smoothly fit into the socialist economy: the coexistence of "large property and small property is fraught with conflicts." One of the important points about these conflicts is that the spreading of small enterprises may reach a critical limit, which necessarily exists in a socialist system. The author puts forward certain suggestions to help the growing units to transform their form of ownership, i.e. to solve the conflict.

Katalin Falus-Szikra has composed her book in a clear and logical structure, discussing—in subsequent chapters—the ways of growing wealthy, the forms of property, the distribution of property and the problems of stimulating and constraining the acquisition of property, and finally, the forms and special characteristics of the functioning of small property connected to the production conditions. It follows, however, from the chosen structure of the book that certain subjects repeatedly appear (for example, problems of ownership of dwellings, or the questions concerned with the interest rates of savings deposits and credits). This leaves the reader with a somewhat disintegrated picture. The author should perhaps have discussed certain subjects in a more comprehensive manner from certain important aspects, accepting certain duplications. In other places, quite unnecessary overlaps are found.

Between the dates of writing and publishing the book, the small enterprise sector discussed in it has grown considerably. Therefore, a part of the data base of the book was already out-of-date at the time of publication, which must be called to the readers' attention in order to avoid misunderstandings.

This book by Katalin Falus-Szikra provides interesting reading. It does not cover up the conflicts, yet it does not magnify them either, but discusses the various positions taken, as well as the conflicts concerning small property and its operation, in a good sense of reality and with an outlook to the future. The author has also taken care to outline possible ways to be followed in the future. Therefore, the book is likely to arouse wide interest.

G. RÉVÉSZ

TÖRÖK, Á.: *Komparatív előnyök* (Comparative advantages). (International cases, Hungarian experience). Közgazdasági és Jogi Könyvkiadó, Budapest 1986. 226 p.

That foreign economic relations are of great significance for the Hungarian economy has by now become self-evident to every citizen of Hungary. At the same time, the origin of the problem i.e. the nature of the domestic economic environment determining the ways of handling economic policy problems is by far not so evident, not even for the specialist. This may partly be explained by the fact that, while the first criticisms levelled at the functioning of the old mechanism were concerned with the profitability of foreign trade, in economics there still are a number of open issues concerning the role of foreign trade in the socialist economy. That is why Ádám *Török*'s book is welcome, already on account of its chosen subject: relying on the major trends of international economics, and on international economic experience, it makes an attempt to understand, and to make understand, the nature of Hungarian foreign trade and its tensions.

The events of world economy of the recent decade have highly upgraded foreign economic performance in judging each country. What are, however, the criteria by which foreign trade is the ruling principle in world economy? The author's starting-point is the paradigm of comparative advantages generally explaining the basis of the division of labour, and having become widely known in connection with foreign trade. He puts Heckscher-Ohlin's theorem in the centre and arranges the theories that have been formulated since then, more exactly since the formulation of Leontief's paradox, relying on theoretical considerations of the foreign trade consequences of the various countries's factor endowments and the factor intensity of the different products. The arrangement of the extremely wide range of theoretical schools upon this basis (i.e. around the neo-factor theory of three factors, separately considering human capital) is highly useful: it provides the Hungarian reader with a firm footing from where to obtain a comprehensive view of the results of the wide-ranging current studies of foreign trade. And this gives information not only about the history of theory, but also about the critical spirit of scientific research, making the reader closer acquainted with the creative spirit of debate so important in scientific development.

Separate mention must be made of the distinction the author makes between the revealed and the actual comparative advantages. This is important from two aspects. First, theoretically, as it contributes to the unambiguity of scientific investigations. Second, from the economic policy aspect, as it calls attention to the importance of the relationship between the two.

This, however, raises the question of quantifying theoretical formulations, which is the subject of the chapter that starts with a re-formulation of the actual and revealed comparative advantages in conformity with this requirement. In setting forth the measuring methods of factor endowment and factor-intensity, as well as the shortcomings of these methods, the author does not depart from the theory of foreign trade: to judge the actual comparative advantage, it is necessary to assess the factor proportions of domestic economy, and to make an international comparison of them. Thereby, however, the book provides an extra: it makes methodological statements which may be worth considering for those engaged in other fields of economics (for example, what kind of approach can be used in examining the substitution of production factors). Finally, basically relying on Béla *Balassa*'s research in this field, the author presents the methods of numerical analysis of the revealed comparative advantages.

Equipped with theoretical and methodological information, the reader arrives at *Chapter 3* of the book, which unfolds five case studies. The method of discussing the relationship between actual and revealed comparative advantages specific of the different countries is somewhat changing. This is due mainly to the fact that in the case of the US the author first of all discusses the facts of the disputes set forth already in *Chapter 1*. Each case is instructive in itself, what is more, they all harmonize on one thing: for the reader somewhat acquainted with Hungary's foreign economic problems, and economic policy declarations, each one offers something *"déjà vu"*. Yet, as the author makes it quite clear: the given peculiarities of specialization are the resultant of an environment showing individual features in several respects. In the case of the U.S.A., though producers shape their product pattern keeping an eye on the domestic market, yet as a consequence of import competition they do conform to the foreign markets as well. In the case of Great Britain, protectionism, i.e. the underlying low competitive spirit and the old-fashioned scale of values have preserved specialization in labour-intensive industries. The situation could not be really improved by the country's joining the ECC, either, since—as the author puts it—, British industry "went behind the trade policy defence lines of the integration at a time when the conditions of the EEC's lag behind world economy were already there." Certain computations show France to be one of the countries richest in intellectual capital. For reasons of power politics, however, this capacity is mainly directed at import substituting production. If is still directed at exports, this happens by using considerable amounts of financial aid (export credits), and towards certain (developing) countries, which results in a significantly different pattern of exports by countries. In the case of Belgium, successful specialization is due to no little extent to the multinational trend, as "already in shaping the microstructure of production, such efficiency considerations are asserted as are measured by international standards." Finally, a very instructive case is that of the recently industrializing countries of South-East Asia showing examples of applying dynamical comparative advantages: the increasing capital-intensity of exports faithfully reflected the changes that came about in factor endowments (domestic capital stock and imports of increasing capital-intensity).

After all this, the question arises: in which way have the comparative advantages of the Hungarian economy developed, or—in consideration of the Hungarian economic conditions—, is it possible to form a judgement of this at all? Namely, the Hungarian market does not measure the production factors; there is no uniform measure of value in the economy, thus neither in foreign trade. Therefore, an analysis of comparative advantages similar to that in the former cases is not possible. Nevertheless, it is possible to present the revealed comparative advantages descriptively, on the basis of enterprise results. With this in view, the author first points out the discrepancy between the available production factors of the Hungarian economy and the actual valuation of these factors, emphasizing that in the Hungarian economy, as opposed to the West European economies, labour and, especially, intellectual capital are undervalued. Thus "the factor-intensity processes of the Hungarian industrial production have been following a direction exactly opposite to the potentials of the Hungarian economy."

In 1978 a new phase of economic policy began in Hungary, in which the requirement of adjustment to world economy was more loudly formulated in official declarations. Relying upon his examination of the 1979–82 data of foreign trading enterprises, the author draws the serious—and well-founded—conclusion that, in consideration of the revealed comparative advantages, the situation had worsened: during that period "the Hungarian industry as a whole did not directly contribute to improving the balance of foreign trade accounted in convertible currencies." A considerable part of the net non-rouble exports was produced by the raw-material- and fixed-capital-intensive metallurgy and the oil refining industry, and the revealed comparative advantage appeared in many cases where exports did not grow, but imports fell. The sphere of the leading exporters to Western countries did not change, while most of them had serious difficulties. Nevertheless, on account of their size and export volume, they were in a position to assert their interests, and thus held enough power to preserve the existing structure. It is therefore, perfectly justified to emphasize the menace that this may lead to the development of an enclave-like exporting sector, even further strengthening paternalistic relationships.

The situation is further aggravated by the different nature, structure, and factor-intensity of foreign trade accounted in roubles, and foreign trade accounted in convertible currencies, and by their changing role in production factor conversion. While the Leontief paradox peculiar to the Hungarian foreign trade asserts itself more strongly than before (within trade with the Western countries, an increasing ratio of Hungarian exports consists of capital-intensive products), the prospects of capital-intensive imports from the CMEA countries are worsening. And this is to say that, with the given structure, the Hungarian economy has to use more of its domestic resources to provide for the increasingly capital-intensive exports to the West.

All these features—the nature of the net exporter enterprise sphere, the Leontief paradox, and conversion tensions—are self- as well as mutually strengthening phenomena in the given economic policy and economic management environment. Declarations concerned with economic policy were not enough to change them, in fact, they are products exactly of the period following the change of economic policy.

Ádám Török's book relying on extensive literature, discussing and further developing theoretical, methodological, world economic, and Hungarian practical subjects may give rise, by its very nature, to the formulation of a multitude of concurrent or divergent opinions. As for the formulation of further questions, the author himself holds the first place: at the end of his book, he submits a list of subjects for research with a view to assure further progress. As for comments, I would make three:

1. In treating the slowness—in any case, real—of the development of comparative advantages in Hungary, the author fails to mention two facts which would make the picture more complete. First, that the study of comparative advantages had been for a long time unwanted here,

which had certainly made research of this field more difficult. Second, that the article by *Liska* and *Máriás,** mentioned without the authors' names, as well as the studies of export profitability indicators carried on in the early 1960s constitute an organic part of the history of the theory of comparative advantages in Hungary, even if not based directly on the comparative theory (and especially not on its Heckscher-Ohlin version).

2. While the author is, as a rule, very particular in formulating concepts, he treats the concept of openness—provoking several disputes in the recent decade—in a rather confused manner. At the beginning of the book the statement is made that the theory of comparative advantages is for analysing the development of countries with an open foreign economy, whereas it is not clarified, what is to be understood thereby: trade policy, intensity of turnover, or something else. The confusion becomes serious when, after making such statement, the first particular case treated is that of the U.S.A., qualified as a country "with the lowest degree of openness", "relatively closed", and even "with a relatively high degree of autarky". This is especially disturbing as the latter concept, as used in Hungary, clearly refers to an economic and trade policy phenomenon: the qualification of the early 1950s as years of autarky is generally accepted, though Hungarian foreign trade turnover was dynamically growing at the time, at a faster rate than the whole of the economy. If, however, the concept involved is one of trade policy, it cannot be applied to the U.S.A., as one of its characteristics is, as the author himself says, that producers adjust to imports competing with them on the domestic market.

3. Finally, in the analysis of the Hungarian case, I find there is a contradiction between the authors' justified statement to the effect there is no such uniform measure of value in the economy by which to value production factors, and the emphatically and unambiguously formulated assertion according to which labour has been devalued in Hungary. Namely, the former statement suggests that the nature of this market is different from that of another where price is the primary regulator or where enterprises are in the final account motivated by profit maximization. And, if this is not so, i.e. as a part of this, the production factors have no free market which would at the same time present hard business constraints, the enterprises are not interested in the efficient utilization of production factors', while there is an intensive demand for these factors. This has to be stressed because, if it is not clearly stated that the Hungarian economy is at present wasting both production factors, and so much is only suggested that labour has been devalued, this may give rise to the illusion that the problems of the relationship between production factors can be resolved by a single large-scale wage-rise.

"The improvement of theoretical systems is only possible, now more than ever, with the economic policy aspects taken into account"—Ádám Török writes. He gives a good example of it himself. This is true, however, also conversely. Or, as he writes himself: the revealed comparative advantage, i.e. the export pattern (to be considered as a given condition in the short run) develops as a resultant of the actual comparative advantages and of the economic policy environment. In this spirit, the book is recommended to decision makers of both today and tomorrow.

I. SALGÓ

DREXLER, A. (ed.): *Modernisierung der Planwirtschaft. Konzepte, Trends und Erfahrungen in Osteuropa.* Mit Beitraegen von Wlodzimierz Brus, László Csaba, Peter Dobias, Jiři Kosta, Rezső Nyers, Andreas Wass von Czege. Goettingen: Sovec, 1985.

The title of this collection of articles, speeches and one interview—Modernization of the planned economy—is somewhat misleading. For the common denominator of the contributions presented is change in socialist systems rather than modernization (the latter rather suggesting technological change within a given system).

Peter *Dobias* of Gesamthochschule Paderborn gives an historical overview on economic

* Liska, T.–Máriás, A.: A gazdaságosság és a nemzetközi munkamegosztás (Economic efficiency and the international division of labour). *Közgazdasági Szemle,* 1. 1956.

reform in Eastern Europe and the Soviet Union. Dobias regards the difference in economic conditions, mainly in the level of industrialization, between the East European countries (to which the Soviet model of planning was transplanted after World War II) and the Soviet Union itself, as the main cause for recurring pressure for reform in Eastern Europe. His presentation of the ups and downs of reform in Eastern Europe is instructive though it excludes Romania and Bulgaria. The chapter concludes with a description of policy options and dilemmas facing Eastern European leaderships when deciding on whether and how to implement reforms.

Wlodzimiers *Brus* of Trinity College, Oxford, (in the first of his three contributions included in the volume), pinpoints the following arguments for the Soviet Union favouring adoption of Hungarian-type economic reforms: lack of alternative ways to improve the efficiency of the system of planning and economic management; the stability of Hungary's political system; and some positive economic consequences of Hungary's reforms such as improved equilibrium, especially on the consumer market, and high agricultural production. On the other hand, Brus sees disincentives to copying the Hungarian reforms in their difficulties to significantly improve economic efficiency, in special interests of the Soviet administrative apparatus and in conservative attitudes among the population.

The chapter "Reform and pragmatism" by László *Csaba* of the Hungarian Academy of Sciences' Institute for World Economics describes the intra-CMEA discussions, on both the political and academic level on how to proceed in CMEA affairs. Diverging opinions on whether and how to harmonize national economic policies and economic mechanisms and to promote direct contacts between enterprises in different member countries are traced in academic publications and between the lines of official documents.

Brus' second contribution offers a brief but elegant explanation of the causes of systemic conservatism in the Soviet economy by deducing the characteristics of the Soviet economic system from, ult)mately, the strategy of accelerated industrialization. That strategy meant maximising output and employment in industry and thereby removed demand constraints on the economy—which the author regards as positive—but also impaired cost-consciousness on the enterprise level which in turn produced shortages and created the need for a system of central resource allocation in physical terms. This system now impairs motivation and information flows by eliminating self-regulatory forces, by destroying the signal function of prices, and by creating diverging interests on the different hierarchical levels of the economy which further impair the quality of information available to the planning authorities.

In his third contribution Brus returns to the relationship between economic and political reform. He observes that past reforms in Eastern Europe had been successful when limited to the economic sphere (Hungary 1968, Yugoslavia 1950). But there is another though not (yet?) evident connection between economics and politics in socialism, according to Brus. The system of central planning will not survive unless democratic reforms are undertaken. For planning needs legitimization; personal accountability of planners for negative consequences of their work can only be practiced on the political level, through resignation (no planner would be able to afford compensation for the damage caused!); and more transparancy of decision making processes is needed to allocate personal responsibilities. All this calls for democratic changes.

Jiři *Kosta* of Frankfurt University elaborates on how to connect plan and market. He starts by enumerating the deficiencies of planned economies (see above) and those of the market, like income disparities, externalities and the need to protect certain spheres of society—education, culture—from the market. He then proceeds to muse on how market economies can be made more socialist and advocates a prudent and flexible strategy. The latter is to aim simultaneously at more workers' participation (Mitbestimmung), the growth of the cooperative sector including "alternative" enterprises influenced by the "Green" (environmental protection movement), equity sharing schemes on both the enterprise and the national level and nationalizations "of large concerns especially in the key sectors of the economy" but without creating monopolies.

Andreas *Wass von Czege* of the University of Hamburg discusses whether the resolution of the Central Committee of the Hungarian Communist Party adopted in April 1984 represented a continuation of the 1968 reform or a change of course. He notes that one part of the changes enumerated in the document—those in the tax, price, and wage regulation systems—reflected the wish to cope with deficiencies of the Hungarian economic mechanism unforeseen at the time of its implementation (1968 and later). Another part—the introduction of workers' participation through workers' councils and full assemblies of enterprise workers—is appraised as a genuine novelty.

The book concludes with a long interview given by Rezső *Nyers,* the HSWP Central Committee secretary for economic affairs at the time of the 1968 reform. Nyers strongly advocates the pursuit of reforms to make socialism more attractive. He mentions the importance of "national diversity"; of an accountable state administration; of diversity of opinion within the Communist Party; and of a system of representation of special interests.

The volume thus presents a *tour d'horizon* on socialism and reform which, without claiming to be representative, may be of interest to expert as well as lay readers. The increased momentum of reform in the Soviet Union since Gorbachev's accession to power will certainly enhance that interest.

M. FRIEDLÄNDER

COMISSO, E.–TYSON, L. D' A. (eds): *Power, purpose and collective choice. Economic strategy in socialist states.* Cornell University Press, Ithaca 1986.

This book includes 14 essays, most of which first appeared in Volume 40, Number 2 of the journal *International Organization.* The authors examine the adjustment of small East European CMEA states (with the regrettable omission of Albania, Bulgaria, and Czechoslovakia) to be changes in international economic circumstances during the 1970s and 1980s. The comparative approach adopted looks at parallels and differences in the reactions to international economic changes, which are analyzed both among the countries of the region, and between the region and other more or less comparable regions: the newly industrializing countries (NICs) of Latin America, East Asia and Southern Europe. Yugoslavia, a socialist country though not member of the CMEA, is a "bridge" between the first and second group of countries; its adjustment problems and processes—unlike those of other NICs—are given deep and detailed treatment.

The analysis is interdisciplinary, including economic, historical and political analysis. The book takes its inspiration from Peter *Katzenstein*'s *"Between economic power and plenty".* The latter book, analyzing foreign economic strategies chosen by the OECD states, makes a powerful argument for the importance of domestic factors in determining a state's international position.

The editors initially intended to compile a socialist sequel that would have complemented the Katzenstein volume, hoping that a structural approach would also yield persuasive explanation for an intra-CMEA comparative study. However, as the book took shape, that hope failed for several reasons. First, in the small, resource- and/or capital-poor countries of Eastern Europe even domestic policy choices proved impossible to explain without reference to external factors. Second, partly because of these exogenous factors, the domestic structure of the states in question is so similar that it did not prove to be a determining variable in accounting for the rather different economic strategies these states selected in the 1970s and 1980s.

The introductory remarks of the authors, quoted in the previous paragraph, seem to belong to the most important conclusions of the book. The extremely strong dependence of the region on foreign factors—especially on developments in the non-socialist world—is far from having become commonplace, at least in the region itself. As for the different economic strategies in the framework of similar structures, they are rather novel: in the 1950s even the detailed regulations of bank lending had been practically identical in the region, and changed in parallel fashion. Even in the 1960s nothing that was worthy of the label "strategy" was really different among the countries.

Ellen *Comisso*'s introductory study gives the general framework and orientation of the research. A political scientist who has carried out extensive fieldwork in Eastern Europe, Comisso rejects persuasively the traditional explanations—class analyses, the organizational-bureaucratic paradigm, etc.—of policy-making in European socialist countries. She turns to an explanation based on state structures and political processes.

Katzenstein's concept of structure, as modified to adapt to Eastern Europe, has four dimensions. First, the degree of centralization in the state and economy—which is extermely high in the region. Second, the degree of differentiation between the state and the economy—which is low. Third, specific foreign policy commitments—relations with other CMEA countries, including its leading power, the Soviet Union. Fourth, the leading role of a single, Marxist–Leninist party. Comisso underlines the point that structure creates possibilities, gives political resources to actors, but it does not determine the political process.

Dealing with the latter function in post-war Eastern Europe, the author presents two basic models: patrimonialism and collegiality. Patrimonialism was the norm in the region until 1953, and it survives today only in Romania. There is an "elective affinity" between this type of political process and the economic development strategy of rapid, extensive growth. The former also tends to imply fast, hard reaction if international economic disturbances threaten to restrain the leader's sovereignty. On the other hand, collegiality, as a rule, favours more incrementalist growth strategies, and also has other economic implications. Comisso, on the basis of the Hungarian and other experiences, gives an inspiring analysis of the typical features of collegiality: the presence of different tendencies in the leadership, the system of mutual checks and controls, the separation of party power from state authority, the bureaucratization (in the positive, Weberian sense) of the state apparatus—without forgetting the peculiarities and implications of the specific kind of collegiality of Poland in the 1970s. Political processes, rather than state structures, were reflected in the divergences of foreign economic strategies of East European socialist countries.

Laura D'Andrea *Tyson*'s essay examines the East European debt crisis and adjustment responses in comparison with the corresponding processes of Yugoslavia and other—East Asian and Latin American—NICs. All the examined countries lost in foreign trade conditions in 1973 and again in 1979; all of them gained in foreign borrowing conditions in 1973 and lost in 1979 and after—thus making a comparative treatment feasible. Particularly interesting is the analysis of policy reactions after 1979: they represented a further accentuation of export-led growth strategy in Eastern Asia, and had a forced character everywhere else: austerity policies led to output losses, etc. Different patterns of distributing the burden of austerity seem to have worked. In the countries of Eastern Europe there are signs that the experience of austerity is promoting a rethinking of development strategy and, in some countries, a renewed interest in reforms of the economic structure. If Eastern Europe wants to halt the recent tendency of widening of the East-West technological gap, it has to re-accelerate technological imports—but this time trade flows have to be more symmetrical, which means that an export strategy is required. An alternative would be greater inward orientation, which seems to be tempting for Bulgaria, Czechoslovakia, and Romania. However, it is in the long run much less promising, and also contradicts Soviet demands for higher-quality industrial goods in exchange for oil and the like.

Michael *Marrese*'s essay analyzes the political economy of the CMEA. The author's basic hypothesis is that an interpretation of intra-CMEA trade has to take into consideration the granting of implicit subsidies in the form of deviations of CMEA-prices from world market prices; another factor in the hypothesis considers granted political advantages. Possible equivalences of this trade are searched for on the basis of research carried out together with Jan *Vanous*.

Iván T. *Berend*'s essay addresses the historical evolution of Eastern Europe as a region. This specific part of Europe, being situated between different cultures, was already displaying specific traits at the very beginnings of medieval European development, in the 5th to 8th centuries. Beside common features of the history and culture of the vast area from the Elbe to the Urals, it is also very important to distinguish the essential differences within the region: Russian East Europe and the Balkans differ from Central East Europe substantially.

The end of World War II was an obvious time of discontinuity for the region. Directly after 1945 the aspirations for change were partly oriented westward. But, as a result of power relations within the world system, from 1947–1948, Western solutions did not prevail: a socialist model came into prominence. However, the specific Soviet model was enforced and copied, even by Yugoslavia. This process rendered Eastern Europe more homogenous than it had ever been before. Still, there are also tendencies of differentiation. The author refers in this respect to Yugoslavia—a self-managed market economy—and to the Hungarian reforms.

Ronald H. *Lindern* examines in his essay Romania's reaction to the changes in the world economy in the 1970s and 1980s. The country's response to the first oil shock did not differ markedly from those of other East European states: despite its extensive economic relations with the non-socialist world economy, it made minimal adjustments. However, after the second oil shock—when Romania was already a big oil importer—also other foreign (the debt crisis) and internal factors made unavoidable the change of the policies oriented to mobilization for fast extensive growth. This time a drastic economic retrenchment took place. In order to decrease—in principle to liquidate—indebtedness without delay, not only investment, but also consumption has been severely restrained. At the same time, in contrast to some other countries, no real reform efforts could be witnessed. The relative importance of intra-CMEA trade increased for Romania. The author analyzes the determining factors, including political processes, of these developments.

The essay by Thomas A. *Baylis* studies the GDR's economic policies in the 1970s and 1980s. The short-term response of the GDR to the disturbances resembled those of other East European states, but the degree of adjustment required proved to be less wrenching than elsewhere. The country—unlike most of its allies—was able to increase its Western exports significantly, and its output growth has remained reasonably fast. Investment was reduced, but not consumption.

The long-term responses of the GDR may be divided into three main components. The first is "socialist intensification": a set of measures aiming at the reduction of inputs while continuing to expand production. The second is a "further perfection" of the socialist planned economy. The changes implied by the latter are sometimes called in the West "reform in small steps", and although a Hungarian-type "regulated market economy" is not aimed at, the return of certain elements of the Neues ökonomisches System, abandoned at the beginning of the 1970s, is quite obvious. The third element of the long-term responses is reorganization of the industry into big 'Kombinate'; it is not yet clear how this is coordinated with the above-mentioned second element. The author analyzes the possible reasons for the GDR's obvious relative success in solving the problems it faced, compared with the responses of other East European countries.

Ellen *Comisso* and Paul *Marer* examine in their essay the Hungarian case. Its *differentia specifica* is that a series of wide-ranging reforms has accompanied austerity measures. The authors give a thorough analysis of the Hungarian political process which has led to subsequent waves of reform measures and recentralizations between them. One of their conclusions is that, from a political angle, recent changes appear to be more difficult to reverse than the 1968 NEM proved itself to be.

Throughout the whole book, in statements concerning East European political and economic problems and developments, the reader frequently meets the "except for Poland" remark. Thus Kazimierz *Poznanski*'s essay on the Polish case plays a specifically important role. The author analyzes the politics and economics of the Gierek era ("unlimited" growth and unsuccessful economic reform in the first, and incomplete adjustment to external economic changes in the second half of the 1970s), and the political and economic disturbances thereafter.

Former Soviet policies, despite massive technological imports from the West, did not mean a real opening of the Soviet economy. Still, according to Jerry F. *Hough*'s essay, the latter may take place under the new Soviet leadership. This and other implications of a supposed (by the Hungarian reviewer cautiously hoped for) radical Soviet reform, with important consequences for the analyzed region, are persuasively analyzed by the author.

Susan L. *Woodward*'s essay analyzes the Yugoslav case. She finds a—given the big changes in international and domestic conditions—striking continuity in the country's policies throughout the 1970s and 1980s with the past. A stop-go type monetary policy pattern and frequent institutional changes belong to the most important elements of the continuity. The author examines the state structure and the political processes which have led to a heavy indebtedness of the country. She underlines, correctly, that Yugoslavia is much nearer to a market-type economy than any other socialist country, and that recent (1983) reform projects tend to strengthen this orientation. But is the Yugoslav economy a real market economy with the necessary level of enterprise autonomy, and are the reform projects in question comparable with the country's radical reforms of the 1960s? The author's answers to these questions are rather close to "yes". The reviewer's answer would be slightly more hesitant, but the difference is obviously one of degree, not more.

The essay by P. Nikiforos *Diamandouros* deals with Greece, Portugal, and Spain, countries with radically different (and during the 1970s radically changing) state structures from those of Eastern Europe. The democratic transformations of these countries contributed strongly—both directly and through having promoted foreign (mainly European Communities) aid—to their relatively successful responses to the changes of the international economic environment.

If one of the keys to success in Southern Europe was getting foreign aid, in East Asia—according to Chalmers *Johnson*'s essay—the parallel key was having lost the aid or the bulk of it in the 1960s. This loss forced the countries of the region to develop economic strategies. The chosen export expansive policies have been successful both before and during international economic disturbances.

Albert *Fishlow*'s essay presents the ways—in many respects very different (although with import substitution strategies, generally connected)—in which Latin American countries have arrived at their current high indebtedness. The author stresses that the region, unlike most East European countries, wants to preserve integration into the international economic and financial system. The reviewer thinks that a disclosure of the real nature and extent of the difference in this respect would need deep, ramifying researches. Only then might we get closer to the really crucial question—whether Eastern Europe's future relationship to the system in question can be better predicted on the basis of the countries' present viewpoints, or on the basis of possible trends in the changes of these viewpoints which have occurred during recent decades. Of course, this is beyond the scope of the topic addressed in the book.

In the concluding essay of the book, Comisso states that (a) in East Asia and Latin America the choice between import substitution and export-led growth depended on the discretionary decision of ruling élites—on the political process—, whereas (b) in Eastern Europe the state and economic structure did not allow a real alternative to the adopted import substitution policies. As concerns (a), I think that in the absence of a minimal degree of political stability (thus so in many countries of Latin America) it would be hard to tell who decides among supposed strategic alternatives. Under such circumstances the real existence of these alternatives is doubtful. However, it would be difficult for me to argue further about this topic because of the limits of my knowledge.

It might be even more difficult to argue with the author's statement (b) which concerns my main field of interest. The statement seems to be basically sound. Yet an important problem may be the complexity of possible relationships between the "process"—which also includes reform processes in several East European countries—and the "structure". Comisso (in the introductory essay, p. 32) describes Hungarian economic decentralization as another case (beside the GDR or the Romanian model) built on a basically identical structural feature: low differentiation between the state and the economy. Again a sound statement. But where exactly are the boundaries between structure and process? What may be the scope of feedback effects exerted by the latter on the former? What may be the reach of possible future reforms? Asking this series of less and less scientific and, at the same time, more and more important questions is, of course, not a debate with the authors of the book who, in the framework of their scientific analysis, do not really address them. Still, good scientific analyses—at least those in social sciences—not only deepen the understanding and knowledge of the problems studied but also incite thinking about unscientific questions. Both hold for the volume reviewed here.

K. A. SOÓS

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* We acknowledge the receipt of the enlisted books. No obligation to review them is involved.

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dr. István HAGELMAYER, see Vol. 33, Nos 1–2.

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dr. György SURÁNYI, see Vol. 32, Nos 3–4.

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dr. Katalin FALUS-SZIKRA, see Vol. 36, Nos 1–2.

dr. Gábor KERTESI, see Vol. 35, Nos 3–4.

dr. Eszter CUKOR, b. 1954. Research worker at the Department of Labour Economics, Karl Marx University of Economics, Budapest, With G. Kertesi co-author of "Differences in pay and modes of earning" in: Galasi, P.–Sziráczki, Gy. (eds): Labour market and second economy in Hungary (Campus V., 1985).

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dr. István GÁBOR R., b. 1948. Cand. of econ. sci. Assistant professor at the Karl Marx University of Economics, Budapest. Formerly visiting assistant professor at the State University of New Yersey, 1983–1984. Author of "The major domains of the second economy" in: Galasi, P.–Sziráczki, Gy. (eds): Labour market and second economy in Hungary (Campus V., 1985) with Gy. Kővári co-author of "Earnings in enterprises and allocation of labour: government control vs. spontaneous mechanism" in: Sziráczki, Gy. (ed.): The state, the trade unions and the labour market. (1986) and several studies in Hungarian.

dr. Tamás HORVÁTH D., b. 1954. Research worker at the Department of Labour Economics, Karl Marx University of Economics, Budapest. With E. Sik co-author of "Young economists on the labour market" and an other study on the same topics in Hungarian.

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EDITORIAL

Current economic thought and public opinion on the economic situation and policies in Hungary are influenced by a number of negative elements. Due to stagnation and mounting disequilibria both in domestic and external balances in the past three years earlier hopes for the success of the economic policy cures applied since 1979 have vanished. Dissatisfaction with the actual state of the economy is widespread. Many fear of a downward spiral of economic development that can no longer be halted. Under these circumstances different groups of economists have tried to formulate programmes for a short-term stabilization linked with a major transformation in economic policy and the management system of the economy. Some, like that prepared for the Hungarian Economic Association have been published; others have remained unpublished or have only been partly published in different economic journals. Since these papers were written, the Central Committee of the Hungarian Socialist Workers' Party has launched a Working Programme and the Parliament has approved a New Government Programme concerning economic policy and the continuation of the economic reform. In this issue of the journal we present one set of the above-mentioned writings of Hungarian economists, with the intention of informing our readers of their contribution to solutions for the present economic difficulties.

A larger team of economists, under the auspices of the Patriotic People's Front, formulated their ideas about reform and economic evolvement under the title of "Change and reform". This study was discussed at several meetings. In the wake of the debates five members of the said team summed up the substantial message of "Change and reform" in a paper. This summary paper was discussed in April 1987 by the Economic Panel of the Central Committee of the Hungarian Socialist Workers' Party. They later formulated their standpoint and made it available to the public. Comments by individual members of the Panel were also published. A major part of this issue is devoted to the deliberations surrounding "Change and reform" and authoritative opinions about it.

Another significant area of debate is also presented in this issue. As part of the changes in economic policy, the Hungarian government has, for more than two years, been preparing a proposal on the introduction of general personal income taxation.

Such a system has been absent from Hungary for the last forty years; the government has also been working on a change from the present differentiated consumption taxation and other enterprise taxes to a more-or-less uniform value added taxation (VAT). It is quite evident that the personal income tax provoked a large and hot public debate. A short presentation of the aims and means of the personal income tax is thus followed by a critical evaluation by an eminent scholar in this field. This article has been chosen from a large number of disputatious contributions. A reply to the criticism is given by a responsible official from the Ministry of Finance.

The 1987 autumn session of the National Assembly passed the Acts on the value added tax and the personal income tax (with some votes against and several abstentions).

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A DEBATE ON "CHANGE AND REFORM"

CHANGE AND REFORM

L. ANTAL–L. BOKROS–I. CSILLAG
L. LENGYEL–GY. MATOLCSY

Events in the eighties, especially in the period since 1985, have shown that the Hungarian economy is in very serious trouble. Repeated attempts to consolidate the economy have all failed, as have efforts to initiate a transformation process that could gradually halt the growth of indebtedness and eliminate all the forced measures (forcing exports, limiting imports, repeated strict financial regulations, administrative interference, etc). In fact, matters are again rapidly becoming worse. Partial liberalization and measures taken to promote the revival of the economy, instead of leading to improved performance, have led to the sudden increase of external and domestic imbalances. Maintaining our solvency again requires exceptional measures and social sacrifices.

The real problem is not that achieving a *permanent,* stable balance has been a slower process and has been carried out less efficiently than was expected in the late seventies and early eighties, which therefore requires larger sacrifices from the society than planned. The main trouble is that there is little hope for structural adjustment which could become the engine of future progress, and which have hardly started yet. The increasing number of crisis phenomena do not promote adjustment, but rather have a paralysing effect. A peculiar, socialist form of stagflation has set in, in which high rates of inflation are accompanied—unlike in market economies—not by unemployment, but by continuously diminishing domestic absorption and worsening efficiency of utilization of resources (e.g. means of production and labour).

For some years now both enterprise managers and the central economic leadership have been aware of the seriousness of the situation and its implications. Unfortunately, even consumers are unavoidably affected to an increasing extent by the deterioration of economic performance. Meanwhile, there is diminishing confidence

* The authors of this article are the editors of a study completed by a larger group of authors for the Patriotic People's Front (PPF). This study was discussed both by the Social Policy Council of the PPF and the Economic Panel operating beside the Central Committee of the HSWP. This article was written on the basis of the larger study and other background materials, and also benefited from the comments and suggestions of the above mentioned fora. We wish to thank the group of authors.

It should be noted that a number of foreign media dealt with the study without the authors' authorization.

that the announced changes in economic policy and economic management—"small steps, perfecting the regulators"—are sufficient to stop the unfavourable tendencies.

These dangerously accumulating negative tendencies cannot be explained solely by unfavourable trends in the socialist and capitalist markets, although these are certainly causing Hungary serious losses. Although shortcomings are evident on all levels, it cannot be maintained that there was no fault in the concept of economic policy and that only the implementation was wrong.

The energy of the present economic policy and economic management is wasted on the elimination of the most urgent dangers, and, owing to the lack of additional resources to distribute, even this task can only be done with worsening efficiency. It is becoming increasingly difficult to turn off this well-worn track. The longer we delay, the bigger the break with past economic policy will have to be, and the more damaging the conflicts and temporary losses which could accompany the necessary radical changes. There is an increasing danger that we shall become entangled in a protracted crisis, and also that some people, who do not understand the nature of our situation and are unrealistic about its possibilities, will suggest solutions that advocate law and order, "fair" strictness, and the elimination of any sort of local initiatives, thus renouncing the idea of mobilizing the creative forces of society and promoting entrepreneurship.

In our opinion, in this situation the only solution with prospects for success is a *radical change* in both economic policy and the system of economic management. *In economic policy* priority must be given to increased profitability (income producing ability) and to enforcing structural changes that help adjustment to the world economy. An additional aim should be the restoration of the external balance within a few years' time. All other priorities must be abandoned: the stabilization of the enterprises' position must be renounced as well as the maintenance of the present standard of living and anti-inflationary policy. In these fields the most the state can do is to soften the changes, and it must do so. Concerning economic management, the government must return to the Central Committee resolutions of 1966 and 1984 on the reform of the economic mechanism. By acting in their spirit and further improving them, and by being determined to implement them, there is a realistic possibility of halting the tendency of falling behind international development and of maintaining the results already achieved (not only in the economy), which were obtained primarily through the introduction of the reform and which were met with well deserved international recognition.

The reform programme cannot be limited to a narrow definition of the economy; it must cover societal policy (and within it social policy) and the system of political institutions as well. The changes that are of pressing necessity now will be accompanied by serious conflicts in the future: enterprise closures, bankruptcy, reallocation of labour and structural unemployment. The relatively speedy restructuring of incomes among individuals and enterprises must be tolerated, while income levels should stay basically the same. The liquidation of certain enterprises or the rationalization of management at others will have real consequences for some managers, i.e., they may lose their jobs or take a cut in salary.

This reform programme offers realistic prospects. But we should not raise false hopes that it will bring about spectacular results in a short period of time. Changes of this magnitude and importance simply cannot be implemented in the usual way: by preparing them in small think-tanks and convincing the public to accept them. In this case passive resistance may develop that will prevent the achievement of the programme's aims. Therefore, the preparation of the decision-making process should include not only the government officials and other specialists but also a wide spectrum of the public through the establishment of institutional forms for their participation. Social policy must be adjusted to cope with the new types of conflicts (or at least the greater frequency and severity of serious conflicts). Mobilizing entrepreneurial spirit and creativity is—as we shall try to demonstrate below—the essence of future development, and will require stable rules of the game, guarantees and economic constitutionality. This is inconceivable without a more active role for the elected bodies (supported by specialists), and the conscious utilization of the media, public debate, open fora and the activity of representatives of different interests. These are naturally part of a wide-ranging reform of the political institutions that we shall not elaborate at this time. We can, however, make an attempt to outline what the economy requires of the political mechanism.

The precondition of breaking this deadlock is the consistency and social credibility of the radical change. What needs to be done is not the "same but better", but something completely *different*. Instead of continuity (some elements of which will still be maintained) it is the elimination of the existing harmful tendencies on which we must concentrate. However, the recent practice can be changed only if the party and the government:

1. initiate the critical and self-critical evaluation of the way in which economic policy and economic management have been carried out and take upon themselves to break with this practice;

2. initiate a dialogue with society evaluating our situation and our possibilities, and about the potential for wide-ranging reform.

Only a public programme, open to debate, one that can be called to account, can give credence to future policy. We wish to contribute to the preparation of such a reform programme with our analyses and suggestions (which will, however, be confined mainly to the economy), being aware that the programme outlined below is not the only one possible and that our ideas are not fully developed in every sense. Yet time flies, and really mature suggestions can only be born in debate.

End of a period

The Hungarian economy has been in a critical situation since the beginning of the eighties. Maintaining our solvency requires repeated enormous efforts. In the meantime, the illusion of a rapid economic revival has to be given up for the renewed battle to eliminate the urgent short-term tensions. In retrospect, it is evident that the programme of speeding up the economy was not founded on a sound economic basis. Wishful thinking took over in our analyses and economic programmes—just like in the press.

The serious problems became evident at the end of the seventies. Since the turn of the decade low economic efficiency, the weak ability to adjust, the decreasing share in the world market, increasing technological gap and the exhausted dynamism of the traditional structure of CMEA trade (exchange of raw materials, primary energy, and machinery under conditions favourable for us) were manifested in the short-term tensions in the external balance. In this way we can see the consequences of the debt crisis almost every day. The theory of rapid and unlimited growth—i.e., not limited by demand in a planned economy—lost its credit long ago.

The mid-1960s witnessed the end to the period of low capital intensity accompanied by a high growth rate, which had been achieved by a continuous increase in the share of large industry in the economy: the transfer of capital resources to industry; the rapid increase of labour employed in large-scale industrial production; the neglect of infrastructure. The Hungarian Socialist Workers' Party (HSWP) recognized that it was not simply a question of the redistribution of resources among the main sectors, but that emphasis should be shifted on the quality of development. It also recognized that success depended on whether the creativity of the society could be mobilized by increasing the autonomy of enterprises and by strengthening the role of market control rather than overall central control. The Central Committee's resolution on reform in 1966 reflected this recognition; it sought a solution that could benefit from the advantages stemming from autonomy, local initiative and interest in market success, and that ensured a role for central economic planning as an accelerating and harmonizing factor of progress rather than a barrier to independent action or a rule unifying economic behaviour. Thus the organic link between the central plan and the regulated market was established for this reason.

The first couple of years following the introduction of the reform proved this recognition to be correct. The balance of the consumer market improved visibly and efficiency figures were favourable in spite of the increasing efforts to develop infrastructure (especially housing). Our performance on convertible currency markets (exports and balance of payments) changed for the better as well. All this was achieved in spite of the numerous compromises—partly correct, partly unjustified in retrospect—which hindered the positive impact of the reform. The elimination of *artificial* monopolies did not take place, although the giant monopolies established under central directive planning reflected the logic of an archaic system, hindered market competition and preserved the strong intertwining between central management, local authorities and enterprises. In several ways the direct dependence of enterprises on central managerial bodies survived. The revision of central managerial organizations, the rational limitation of their role and the establishment of the organizational institutional system of a capital market were also postponed, cancelled on the rationale that structural changes and important investments could only be initiated by the central management (or the plan). Gaining various favours from the centre remained the sole path towards rapidly rising, dynamic development. Reducing the size of firms, or in extreme cases the winding up of enterprises also required a decision from the centre. Bankruptcy—apart from small cooperatives—remained an exception in the system operating following 1968 as well. Briefly: *the rise and fall of enterprises was still based on central selection rather than on market selection, central management did not use—strengthen or ease—market selection, but replaced it.*

Naturally, there is no reform programme without compromises. Some supporters of the reform hoped that, on the basis of the programme which aimed at the higher rationality of central decision-making while maintaining the unlimited possibility of interference, the economy would become the battering ram that would gradually transform the behavioural norms of society, and sooner or later would bring new features in the operation of the political institutional system as well. Others trusted that the enlightened reform measures introduced in due time would stop any further "erosion". In order to introduce the reform programme successfully, a temporary compromise was needed between the two diametrically opposing views that would leave it to the economic practice of the following few years as to which view would dominate. In any case, the reform that left the predominant role of hierarchical relations untouched provided better opportunities for retreat than for further progress.

A short time later, as early as in the beginning of the seventies, this retreat took place. Thus preference was given to the largest enterprises; central interference increased, as did the number of central development programmes; the role of central investment was decisive; there was a serious erosion of the universal norms of financial regulation; sectoral management was revived; auxiliary workshops and small private enterprises were intermittently repressed. This was equivalent to the partial, and not insignificant, withdrawal of the reform's achievements. Finally an indirect planning system took shape in which bargaining about plan tasks in kind and about material distribution (i.e., *breaking down the plan*) was substituted by bargaining about the conditions of accumulating different financial (investment, wages) funds *(breaking down regulators)*. This type of management was based on the simulation of market logic. Central interference became a substitute for market processes rather than becoming a supplement to or regulator of them. Regulation taking the place of market with its numerous partial stimulators and system of wide-spread financial redistribution is much more efficient than plan directives taking the role of the market (in the form of compulsory delivery contracts), although it is much less efficient than an economic mechanism based on the overall regulatory role of the market. Its advantages manifest themselves in the more flexible operation of the system, in the prevalence of financial tools, and in the ability to absorb the so-called second economy into the total economy, offering this sphere a chance to develop as well. Thus, the economy not only deals with, but utilizes personal initiative that, in this way, is not only recognized as value financially, but is also respected socially.

The mid-seventies are famous for the oil-price explosion and the external crisis. However, easy and cheap dollar credits made it possible to postpone adjustment, while the detailed central management, which did not refrain from using administrative means, left ample room for subjective errors with no consideration for reality. This gave rise to the belief that "we are not affected by the crisis", and caused the worst difficulties in recent Hungarian economic history. The problem lay not in obtaining credits and becoming indebted but in the fact that the external sources of low-interest credits offered a historical chance to restructure the economy without serious social conflicts, and we have missed this possibility: instead of organized cuts in the crisis industries, as took place all over the world, we maintained their rate of development. In this way, we chose a spectacular way of development that has, however, resulted in worsening difficulties and offers no prospects for the future. Our debt trebled in a couple of years, while none of the structural problems has been solved as yet.

The conditions for CMEA cooperation worsened as well. The reduction of primary energy and basic material imports became an effective barrier to our development prospects over the course of a few years. (This primarily reflected the weakness of our ability to adjust and the extremely high energy demand of Hungarian industry per unit of output.) In addition, our terms of trade deteriorated, while the dollar content of socialist exports increased, and the extent of dependence of the ever less competitive Hungarian manufacturing industry on the socialist market increased. In the recent past it has also become evident that the exports of agricultural mass products for dollars to the socialist countries could not stabilize the balance of payments. The shortcomings of the CMEA mechanism, especially the very limited operation of money functions, also caused an increasing number of problems (and not only for Hungary).

The prospects for the near future are not clear. Although we can expect some modernization of the CMEA mechanism, we can also expect our partners to establish increasingly stringent requirements which will result in further losses unless the competitiveness of the domestic manufacturing industry improves. Furthermore, we have reason to fear that enterprises with declining competitiveness will prefer to export to socialist countries—even at the price of placing domestic resources abroad—as a means of postponing the necessary (albeit painful) structural changes. This conservatism is reflected in the argument—otherwise not challenged—which emphasizes the importance of developing CMEA cooperation as a sacrosanct goal. In essence, this amounts to stabbing the rationalization efforts of economic policy in the back. Both laconically and diplomatically, these problems are usually described by saying that the CMEA has lost its power to induce dynamic development.

The basically incorrect, but consistently implemented economic policy of the late seventies was replaced by a more sober economic policy that, unfortunately, was carried out inconsistently. The first priority was to deal with the hard currency current account and trade deficits. This economic policy—in spite of all its faults—made survival possible, but the elimination of the immediate danger was not followed by the elaboration of a strategy to assist long-term development and an economic mechanism to support it.

The economic policy of the eighties was based on three assumptions.

1. The strict limitation of domestic demand—especially of investment but partly of consumption, too—would encourage even the large enterprises, which were mainly interested in the increase of production, to increase their convertible currency exports.

2. An economic policy which concentrated on the increase of convertible currency exports would unavoidably lead to losses; but these losses had to be prevented from being shifted onto the vulnerable domestic market in the form of price rises (this is the essence of the "competitive" price system).

3. A relatively less painful way of reducing purchasing power was through an inflationary economic policy, i.e. by squeezing excess money out of the economy (the spending of which with stable prices would make the export surplus impossible) by increasing the price level.

This economic policy, however, did not prove to be successful, although its initial ideas were realistic. It is not that the restriction was incorrect, since it was essential to limit domestic demand. Elimination of the budget deficit would have been necessary not for narrow-minded fiscal reasons. In recent economic practice the limitation of purchasing power is simply an unavoidable precondition for achieving an export surplus. But the unconditional stabilization of enterprises in difficulty was incompatible with the further development of the profitable enterprises (mainly in manufacturing) that were able to adjust. The budget was transferring a rapidly increasing proportion of the stagnating incomes resulting from the stagnating economic activity to an increasing number of weak enterprises. (Recently this income redistribution has been equivalent to 15–18 percent of GDP.) As a result, taxes are irrationally high in that sphere of the economy where enterprises are in fact forced to pay all taxes (i.e., most of manufacturing), and the budgetary income is still insufficient to cover the increased redistribution needs (which is reflected in an ever higher budget deficit) at the same time. Thus, restriction has resulted in social and economic uncertainty. The difficult economic situation and the uncertain, unstable regulators, subject to frequent adjustment for individual cases, do not encourage rapid adjustment, but instead have a paralysing effect.

With some simplification we can say that we treated the serious economic situation as a business cycle and debt crisis problem. For some years this sort of treatment was in fact justified; easing the short-term dangers was a top priority task. But when we might have hoped that the pressure of temporary tension was over, i.e., when the foreign trade surplus achieved a level which provided a certain amount of security, then we started to look for ways of returning to the path of rapid growth rather than devise a long-term strategy for economic development. Thus the illusion that "we are not affected by the crisis" was exchanged for a more realistic view in the seventies which, in turn, was later replaced by a new illusion that there was "a light at the end of the tunnel". Although the self-confidence of the seventies did not return, there was a considerable sense of relief. When the call for accelerated economic development took over from the general concern about the energy crisis, we hoped that we could avoid some unpopular measures and those phenomena (for example, inflation, unemployment) which are seen by the public as undermining the basic values of socialism.

However, in a socio-economic system where income creation—due to the almost unlimited redistribution of incomes—does not reflect market results but the peculiarities of regulation, the relationship with authorities and the bargaining power of enterprises; and where there is no inner motivation to make a profit at any price, the attempt to accelerate economic growth and to effect a partial liberalization of the rigid measures will not result in an economic boom but in the loss of balance. While the demand for production factors will increase, economic results as assessed by market factors will stagnate or fall. Therefore, there is no way out of the crisis without conflict. This is the most important lesson to be learned from the failure of the attempts to accelerate economic growth in 1985–1986.

Three levels of our economic difficulties

On the surface our economic problems seem to be characterized by the temporary debt crisis, and in fact our economic policy responded to this. These problems are manifested in increased debt, drastic cuts in the rate of investment and lasting economic stagnation. In the past few years a wide-spread and unfavourable impact on the standard of living was also unavoidable. (The real value of pensions and other social benefits has decreased continuously for years, and real wages have decreased to some extent as well, although this was counterbalanced by an increase in other labour incomes.)

Behind the worsening economic tensions there is a *structural crisis* that we sense as the international devaluation of Hungarian labour, i.e., a permanent deterioration of our competitiveness. The sources of our earlier comparative advantage—such as our good position on the world market concerning simple mass products, our special intermediate role *vis-à-vis* the East, the re-export of products imported for roubles with minimum value added and relatively low wage level—are all running out.

Hungary's share in the world market has decreased without interruption since 1975, despite the doubling of exports. Our marginalization is most apparent in manufacturing—especially in engineering—primarily in the markets of the industrially developed countries. The commodity structure of exports is increasingly burdened by the fact that Hungary—as other CMEA countries—is more and more forced into the role of exporter of energy-intensive mass products that can only be sold under deteriorating terms of trade, while it is increasingly pushed out of the export markets of technology-intensive products. Our *terms of trade* have been deteriorating since the mid-seventies (more or less continuously, with some short breaks) and this is caused—in addition to the international tendencies concerning prices—increasingly by unfavourable exchanges within certain commodity groups. The economic policy forcing exports and limiting imports also contributed to the constant worsening of the terms of trade in the eighties. It is therefore not surprising that the capital intensity of production is on the increase and, unlike in the industrially developed countries, energy intensity has not been reduced either. These structural problems are also reflected in the fact that, despite all efforts to the contrary, resources are still allocated to the raw material and semi-finished goods industries, where the principle of security dominates, while the principle of efficiency is pushed into the background. In this way, although a very large proportion of Hungarian output is exported, this reflects not adjustment, but rather the vulnerability and instability of the economy.

The largest and most intractable problems, however, can be found in the economic mechanism, since our structural difficulties are to a large extent caused by the weak ability of the economy to adjust. The changes in our economic system have not been sufficient to establish the conditions for market mechanisms to operate adequately. Structures and elements adjusted to the old mechanism survived in many fields and also moulded the "new economic mechanism" in their own image.

The establishment of the inner motivation *"to operate profitably at any price"* has so far been successfully achieved only in the sector of small private enterprises. This is the area where there is real risk (not only income is insecure but capital can be lost as well), but on the other hand, there are the incentives of property ownership and the chance of success. If there is no motivation to operate profitably, the economic units will not be prevented from the uninterrupted utilization of resources (labour, capital, imports), not even by the prospect of reduced profits; the possibility of diminishing sales thus will not lead to rational self-limitation in investment. Therefore the centre has to take on the task of:

—limiting *the demand for resources,* in this way trying to harmonize needs (demand) and possibilities (supply);

—trying *to make the efficiency principle work* by applying different profitability indices.

The managing authorities are bound to have *only partial* success in this role: since they can only rely on past tendencies (as a basis) in their resource-distributing and demand-limiting activities, they lack realistic knowledge of potential possibilities. Due to weak selection by the market, self-correction hardly works, while the principle of controlling on the basis of past performance favours the maintenance of traditional performance standards. The most decisive feature of this system is that it can change, adjust, and especially learn only with great difficulty. Its main characteristics are:

1. The majority of enterprises (large and medium size ones) remain dependent mainly on the managing authorities and social organisations and only to a very small extent on the market. This determines the manner and direction of adjustment for the enterprises (failure in the market, i.e., bankruptcy, is not a realistic threat to large enterprises).

2. The artificial monopolies of huge organizations are maintained, (and their monopoly position is guaranteed by legal regulations which ensure their privileges, especially in trade and finance).

3. The institutional system of capital markets is non-existent, thus when imbalance between demand and supply occurs there is no institution to assist the adjustment of *supply* on the basis of entrepreneurial interest.

4. The basic structure is hard to change also because *the individual enterprises—like the whole Hungarian economy—were established as closed, inward-oriented autarkic units, averse to having external relations.* Autarky has long ceased to be a priority in economic policy, yet it has remained in the basic interest of the actors in the economy, as an absolute necessity for their security, the decisive factor in their bargaining power.

*

In summary, the existing system of economic management replaces rather than organizes the market. Owing to the lack of a functioning market and competition (i.e., the inner motivation to operate profitably), the economy shows the symptoms of autarkic, *wasteful* behaviour that adjusts slowly and with difficulty. The initial idea was an incentive system which would assist the plan, and the partial utilization of market forces. Later on, we set as our main goal the establishment of a market based on the dominance of planning and organized by the plan. Now the basic question is *whether we can create a genuine socialist market economy based on the dominance of the market in the competitive sector* and *establish planning based on and harmonized with the wide-ranging regulatory impact of the market. For this we need to establish a social environment which:*

—considers entrepreneurship as a basic value,

—is oriented towards success, not towards avoiding failure,

—is able to tackle the conflicts generated by the market.

Preconditions for a new period of the reform

We must recognize that the external economic conditions will most probably further worsen for us. The debt service burden will significantly increase until the early nineties. Direct foreign investment can counterbalance this only to a small extent. The export competitiveness of our products will not improve substantially either. Further external indebtedness aiming at the maintenance of the existing production structure would result in the loss of solvency. Economic conditions within the CMEA will not improve either; a turn in the economic mechanism towards the market should not be expected in the short run either in the individual countries or in the region. The battle against the weakness of the financial mechanism will have only very limited success *in the short term*. In the meanwhile, the trade in "soft commodities" must be reduced, because this will be *mutually* beneficial, even though this step can cause serious sales problems for a number of manufacturing enterprises. At the same time we should aim at establishing a cooperation scheme that does not isolate us from the industrially developed capitalist economies, but promotes structural adjustment and technological progress.

Establishing the conditions for a market reform is made even more difficult by the fact that pushing individual bargains into the background, consistent bankruptcy procedures and the eventual cutback in the crisis industries will not result in additional resources. On the contrary, it will lead to a temporary fall in exports, an increase in import needs (if the fall in production leads to problem in domestic supply), the devaluation of capital and job losses.

In the short run we cannot hope that the development of infrastructure would generate substantial growth in a way that does not burden the balance of payments. (For this a completely different system of financing infrastructure and distributing responsibilities for development between central and local budgets and citizens should be established.) Only a further increase in the share of small private enterprises, and increased possibilities of capital accumulation in this field can have—on the basis of the past few years' experience—a real growth accelerating effect. Although a review of large investment projects, withdrawal of certain development programmes, and some austerity programmes in the budget sphere (especially concerning public consumption) can in fact result in budgetary savings, yet these positive effects are by far not sufficient to counterbalance the social cost of stabilization in the short run. We must therefore accept that the failures of the earlier economic policy place an additional burden on the shoulders of the society in the short run. To evaluate this situation in an optimistic manner, and introduce an "intensification" programme on this basis would result in economic bankruptcy. There is also a serious danger that the optimistic evaluation of our possibilities to grow would lead to further restrictive measures. This might bring into question the seriousness of the changes.

As we can see, the scope of economic policy *diminishes* rapidly, and this has some consequences for the reform process as well (especially for the tax reform being introduced at the beginning of the consolidation process). The possible alternatives for economic policy are the following:

a. The current economic policy, which consciously avoids any serious conflicts, can only be continued for a further two-three years at most. The relatively high level of convertible currency reserves and the available external sources—although with more severe conditions—still allow the party and government management to think over the economic and social cost and future benefit of eliminating loss-making activities. With the situation worsening they will certainly feel an urge to introduce measures limiting the utilization of income, but they will not be forced to stick to these measures consistently according to the requirements of equilibrium and the efficient transformation of the production structure.

b. An alternative economic policy could force economic growth oriented towards the CMEA market. It would be based on a centrally commanded structural transformation. The financial limits to socialist exports and domestic demand could be eliminated, and this would, in fact, give some possibility for certain sectors to grow in the short run. However, the balance of convertible currency trade could only be achieved by strict administrative import restrictions, which naturally would immediately reduce growth possibilities. A choice would have to be made between inflation or a shortage economy in order to tie down the increasing domestic income; but both would result in a lower standard of living.

The main problem of this economic policy variant is that while it weakens the limits to growth in the sectors of manufacturing that are not competitive in convertible currency markets, it does not assist long-term development, because

—one, the servicing of the convertible currency debt necessitates the continuous tightening of domestic income, while the expansion of socialist exports requires further convertible imports,

—two, import limitations inherent in such strategy make technological progress impossible,

—finally, and most importantly, this type of economic policy would result in the "stabilization" of an inefficient economic structure.

c. A programme of immediately stopping the increase of convertible currency debt could be set as an aim as well. However, this would require drastic cuts in imports and forcing exports with administrative means, a method which would not only neglect consideration for profitability, but would definitely lead to the disorganization of the economy. In this way all chances to transform the economic structure would be lost.

d. Finally, an economic policy could be outlined which would set its priority as stopping the increase in convertible currency debt within two-three years and announce a programme of radical structural changes at the same time. In this case there seems to be a possibility of finding the optimal solution for meeting both short- and long-term tasks which antagonistically contradict each other in every other version. The utilization of external resources might be continued—although to a decreasing extent—but the resources obtained in this way *must fully serve the aim of an efficient transformation of the economic structure*. By an efficient transformation of the economic structure we mean that the share of profitable exports would increase, and that of non-profitable exports would be reduced. The best stimulation for this transformation is *a substantial currency devaluation,* combined with the *elimination of individual export stimulants* on the one hand, and the *very strict reduction of domestic income utilization* on the other. Imports could be limited with the same measures.

The limitation—i.e., restriction—of domestic income utilization is also necessary in order to avoid a general increase in consumption and investment through the utilization of external resources. If the utilization of external resources can *only* serve the transformation of the economic structure—i.e., the increase in *profitable* exports *only* partially replacing lost production and exports and efficient investment—then, due to the stagnation of domestic income production and to the restriction of its utilization, *consumption must decrease considerably as compared to the recent level.* The most efficient way of cutting (personal) comsumption is with *price rises and large-scale cuts in the consumer price subsidies* that cannot be socially justified and sometimes are definitely unjust (housing rent, building materials, energy for households, meat, milk, etc.). Evidently, the reduction of subsidies must be compensated for partially, but this compensation must only be *partial* (i.e., it cannot result in a general increase in consumption), and must be *socially efficient* (i.e., it must counterbalance the cuts to a larger extent for those who are most disadvantaged). Accordingly, social benefits set in absolute terms (family allowance, social policy allowance, child care allowance) and pensions should be raised at the same time.

Only this latter, *d.* version is capable of harmonizing stabilization with structural change. Realistically, the increase in debt can be stopped by the early nineties, if we try to achieve this aim not in a destructive way, but in harmony with the policy of structural changes and development of the market.

Characteristics of a comprehensive reform

In order to initiate genuine stabilization, limited partial reforms are insufficient. Only a *comprehensive, radical democratic and decentralizing market reform* will bring the desired results.

The transformation of the economic structure and adjustment to the world market obviously require social sacrifices, which can only be mitigated and the distribution of burdens can be made more acceptable by the reform policy. *An honest and realistic reform policy cannot promise rapid economic growth or improvements in the standard of living in the short run, and it has to admit openly, that it cannot avoid a temporary set-back in economic development. Yet it can provide new prospects; it can establish the conditions for putting a stop to the disorder and create the basis for sustainable economic growth in the nineties.*

We must see that an overall reform is in the interest of the *majority* of the society, but not of the *whole* society. It will not bring about improvement for every social group, and at the beginning even those will not support it whose interests it will serve. The conflicts accompanying the reform are apparent, but there is no guarantee for the positive outcome and consistency of the reform process.

The reform programme should be:

1. *comprehensive;* because the radical changes in economic policy, the major steps in transforming the economic mechanism towards the market, must be carried out simultaneously and supported with social and political reform;

2. *radical;* the first step in finding the way out of the crisis is *the open self-criticism of the government and the radical break* with earlier practice; without this we cannot hope that the programme initiating changes will be trusted, much less supported;

3. *democratic; it must provide greater freedom and independence for citizens and their communities; it must take steps toward political equality (eliminate or limit political privilege, stop the political inequalities in the economy); parliament, municipalities, enterprises and interest representations should have a decisive say in determining reform policies;*

4. *in favour of decentralization;* in the sense that it trusts economic units, local self-governing bodies and representatives of interests with the majority of the currently centralized decisions, which are now beyond the comprehension and control of society; and, in addition to the decentralization of decision-making supported by guarantees, it will also complete organizational decentralization and anti-monopolist regulation;

5. *market-oriented;* this includes the elimination of interference by political and administrative organizations in the operation of the self-regulating market, and should be backed by constitutional guarantees; reliable and controllable central regulation, and finally, the freedom of citizens to choose between market and non-market institutions are such interconnected elements, in the absence of which the establishment of genuine market relations is not possible.

The role of financial management in the reform process

In order to establish a market regulating economic process efficiently, financial management, and within that the role of the monetary and fiscal sphere, must change considerably. The current budget policy, which directly influences the economic processes in all aspects, is a serious burden on the economy. It takes on the role of the monetary sector (regulating aggregate demand) and even attempts to substitute for the market (in the system of regulation which simulates the logic of the market). At the same time, it tries to shift the responsibility for structural policy upon the credit system that, in this way, cannot fully meet its original function.

Monetary restriction

Roles must change. Monetary restriction must get the most important role in the regulation of total demand (and this does not contradict the requirement that all aspects of financial policy—money supply policy, budgetary policy and foreign exchange policy—must be restrictive at the same time). *Monetary restriction,* which will replace administrative limitation, is the centre around which those mainly financial measures can be organized. These measures should channel the external forces influencing the economy not in a paralysing way, but in a manner assisting adjustment; they should start the process of efficiently restructuring the economy, on which long-term economic growth could be based.

The central question of this is the strict regulation of the quantity of money. Not only the credit supply must be regulated with a firm hand, but the total amount of money in circulation should also be restricted. This regulation can only be *quantitative*—relating to the quantity of money and the total magnitude of credit—without any quality preferences.

Consequently, the balance of supply and demand for credits must be established by interest rates. This presupposes a general and probably significant increase of interest rates for both savings and credits in the stabilization period. (Interest on credits for export increasing investment may be partly refunded from the budget if the anticipated exports are in fact realized.) If the bank of issue strictly limits the money and credit supply—first of all by flexibly changing the interest rates for refinancing credits, and later perhaps by open market transactions—then there is no need for the sectoral or in-kind breakdown of the financial funds in monetary regulations. Concerning commercial banks, the rigid administrative separation of financing working capital and investment will also become unnecessary. The strict limitation of budget deficit financing is absolutely necessary for the success of monetary restriction. Without this the monetary sphere will be forced to create money that, in turn, will lead to the further deterioration of the external balance or to a higher rate of inflation or to more intense shortages. The extent of central intervention should be controlled and reduced, mainly by reducing the amount available for production subsidies, tax relief and central preferences. In this aspect too, the *ex-ante* declaration of central preferences and regulators is needed as well as the establishment of the possibility of public control. The independence of the central bank (the bank of issue) must necessarily be increased (from both the central plan and the state budget). Therefore, it would be wise to place the central bank directly under the control of Parliament. The central bank must be able to establish independent monetary policy, including the limitation of economic policy as well.

Monetary restriction offers the chance to eliminate "regulation" by administrative allocation (currently mainly concering imports), individual regulation of different incomes (especially of personal incomes), as well as pressure and rush actions (generally in respect of prices); it should also push the special extra incentives gradually into the background. If the financial system regulates the aggregate demand efficiently, and makes it possible for resources to flow to efficient, competitive enterprises, then administrative limitation will gradually lose sense. In this way any increase in imports or price rises will be limited, not by central regulations but by the lack of money (limited demand).

Monetary policy and tax reform

Concerning budget expenses, there are two areas where substantial saving can be achieved without hindering economic progress: 1. in public consumption; 2. by reducing the subsidies and tax relief given to production. The former can be carried out via a budgetary savings programme, the latter is related to tax reform.

The aim of the tax reform is:

—*deregulation,* i.e., a rapid elimination of the overcomplicated system of fiscal redistribution,

—neutrality in competition; equal tax burden for different economic units in the case of the same activity,

—*fairness in taxation,*

—elimination of the *limiting* aspects of regulation (mainly in the field of income regulation) that hinder rational economic activity.

However, the impact of taxation techniques should not be overestimated. The tax reform replaces a large proportion of taxes earlier paid from the actual profits of the productive enterprises with taxes paid by citizens, partly as income earners, partly as consumers (in the forms of a value added tax and personal income tax). The new system of taxes has the ability to limit central redistribution of incomes between the productive units to some extent, and also to prevent fiscal regulation from playing a demand limiting role (replacing the monetary sphere).

Concerning wage regulation related to the tax reform, we expect it to "get rid of" its earlier "stimulating" functions and, by adjusting to the different organizational systems shaping up in the economy, the regulation will avoid the central distribution character (that is an unavoidable consequence of linking enterprise profits and wages).

Wages have to emerge from a bargaining process—between enterprises, trade unions and the centre—that makes the harmonization of interests possible. (In this way it is possible to eliminate high taxes on incomes or increments in income.)

The pre-reform tax system was an organic part of an economic policy that—although attempting to simulate the logic of the market—wished to maintain the system of bureaucratically selecting the areas that should be rapidly *developed,* and in this way avoiding the conflicts stemming from setback and failure. Not only was the tax system cut up by special solutions, individual interference and subsidies have been soaring since 1982. Prices did not reflect real performance either, and development funds did not go to places where prospects for development were the safest and longest. Enterprises were not truly interested in the increase of profits but in achieving a modest, not too apparent profit. The motivation to obtain long-term profits, and the interest of the owner to accumulate capital, was and still is completely missing. Progress is needed in this aspect as well. Tax reform will gain its real sense in the case of an overall change of the economic mechanism.

Obviously, *without* an overall tax reform no rational structural policy can be implemented (for this the real situation of enterprises and their realistic prospects must be seen clearly), nor can a capital market and system of interest based on the inherent need to be profitable be developed. Cancelling the tax reform would mean that we give up the idea of connecting income distribution to competitive performance. Without this, however, a successful revitalization policy cannot be implemented, since any additional income, not related to useful economic activity, will lead to imbalance. The tax reform on its own is financial technique only. To succeed, self-restriction is needed: the institutional subsidizing of low efficiency areas through taxes must be given up; and so must the idea that the outflow of wages and investment purchasing power should be regulated mainly by taxation (i.e., by changing tax rates). A consistent economic policy is needed that allows the useful but unpleasant impact of stronger differentiation, more frequent enterprise losses and market selection to work.

Exchange rate policy and import liberalization

Concerning the behaviour of domestic income earners, apart from the budget, an important precondition of maintaining the external balance is the establishment of an exchange rate that will make it at least possible for the majority of non-agricultural exports to exist without exceptional financial subsidies (managerial bonuses, pledges, wage preferences, etc.), and by which the possibilities for and limits to rational import substitution will be indicated by the realistic costs. All this requires a substantial *devaluation of the forint vis-à-vis* convertible currencies. Stimulating exports by an efficient exchange rate is better than the current system, for two reasons: it makes it more apparent whether exports are profitable or not, and it does not make the structure of exports rigid, since it automatically favours the efficient exports of new products as well. *Consistent monetary restriction can strongly limit the possibility of shifting the increase in import costs on to the purchaser.* Thus it will maintain the relative advantage of the export sector.

In the period of transition there could be a system introduced where an increasing proportion of funds available for imports would be distributed by auction. Enterprises obtaining these funds would automatically receive a licence to import any product (including consumer goods), but they could sell their import quotas as well. As a consequence, there would necessarily be a double exchange rate that could be maintained only temporarily without serious trouble.

Moving toward consistent monetary regulation and an efficient exchange rate will make the gradual introduction of import competition possible *now*.

Planning

The increased role of financial policy—and within this of monetary policy—requires basic changes in *economic planning* as well. Planning that is now still determined by an in-kind (physical) approach and consists of several rounds and multi-level sectoral and local adjustment of interests must be transformed into financial planning characterized by constant cooperation between the economic super-ministry of the government and the bank of issue. Institutionally, this means that there will be an economic super-ministry (that will be very powerful). On the other hand, the whole logic, methodology and role of planning will change.

In the new system economic planning will be transformed mainly into the preparation and constant refinement of a macro-level financial programme. Its starting point will be determining the conditions for external and domestic financial equilibrium (balance of foreign trade, interest payments, current account balance, etc.), and the estimation of the total income, consumption, saving and accumulation of the different groups of income earners (the state, the population, enterprises, and foreign countries). The next step will be to investigate the need for finance originating from the changes in income and from the "monetization" of the macro-level financial plan. We also must forecast the credit distribution, and (with the consideration of changes in the currency situation) money creation by the banking sphere. The means and extent of monetary policy can be derived from the desirable extent of change in the credit stock, while the need for changes in the tax system and subsidy-system will be indicated by the budget.

In the non-market sections of the economy (especially infrastructure, public institutions and public consumption), planning must play a larger and more direct role. But there are substantial changes needed in this sphere too: the central estimation and ranking of needs cannot be the sole basis of planning (except for the development of cross-country networks). Local municipalities must play a bigger role in the preparation of the plans.

A unified strong market and new forms of social ownership

In addition to rearranging the financial system, another important aspect of economic reform is the transformation of *the system of ownership*. In the previous models of operating the economy the ownership- and organizational forms of long-term interest in asset value maximization were not successfully found. In their absence the economic actors in the state sector do not have a real interest as owners, and at most are only motivated to increase their annual profits.

Although settling the question of ownership is part of a long-term reform process, a short-term system that places more emphasis on long-term interest could be based immediately on the already existing duality of state and private enterprise. In this system a larger variety of public ownership would exist, state ownership would be reduced, the genuine group-ownership character of cooperative ownership would be strengthened, and transition between different forms of ownership would be possible.

The question of ownership is not identical with the question of organizational forms. In addition to the gradual development of the forms of public ownership that represent a long-term interest in asset value maximization, varieties, elements and forms of enterprises and entrepreneurial organizational structure must be developed as well. The gradually developing new forms of ownership increase the scope of organizational forms and the number of participants in the market.

The increase in the number of market participants is not an end in itself, but rather an expedient means for abolishing the existing withholding of performance and low level of interest at the large state enterprises. Within the enterprise this should be carried out by organizational decentralization, which could abolish the interest in withholding performance by giving independence to the units of the enterprise and letting them establish direct market contacts. This could enliven market competition at the same time. The increase in the number of market participants—intertwined with their stronger interest in income—is a step towards a buyer's market; thus it enforces competition.

In the reform of ownership and organizational forms, one presupposes the other. Without ownership forms, representing the long-term interest in asset value maximization, the increase in the number of market participants and organizational forms cannot have a strong impact on performance, and vice versa; in the existing narrow circle of enterprises even new ownership interest would fail to boost performance significantly and make progress towards a buyer's market.

The reform of the financial system requires both of the above described, intertwined ownership and organizational reforms. The reason for this is that a financial system operating with monetary management and restriction would only be able to have a short-term impact in the current enterprise structure, because on its own it cannot establish the elements of long-term interest in increasing profit, and cannot withstand the likely attempts of large enterprises in monopoly positions to loosen the restrictions.

New forms of ownership

—In enterprises currently managed by an enterprise council and a general assembly, the different units of the enterprise could own securities—representing their own assets—about which they could decide independently; they could also decide independently on uniting their properties with those of other collectives, or on transferring their right of self-management to other enterprises, banks, cooperatives on the basis of selling a part or all of their securities.

—New enterprise forms could be established which would trade only with other units' securities, embodying ownership rights of other enterprises, and practice their ownership rights in this way. Freed from the burden of productive operation, these units could work solely on the basis of the long-term interest in increasing capital.

—From the large enterprises currently operating at more than one site, new enterprises could be formed, the units of which would be each other's owners in the form of joint stock companies or limited liability companies, and a common owner of them all would be a centre handling the capital. In this way all units would become interested in the changes in the other units' capital and a long-term interest in increasing the total capital of the enterprise would emerge.

These forms should be experimented with in the period of stabilization, accompanied by the appropriate legal rights and regulations, and then they should be made general in the current circle of self-managing enterprises.

The reform of ownership must bring about new self-governing ownership of local municipalities as well. Citizens can add their income to the income from local (municipal) taxes, bank loans and resources from central funds for different local, communal, educational, health, etc. purposes. Bonds issued by local municipalities for building schools or outpatient clinics should give the right to participate in the investment or in the maintenance of these institutions. In this way local institutions will gradually become the property of local municipalities and communities, and the income of the council (mainly from taxes), enterprises and entrepreneurs and private savings can be utilized together.

Slef-managing ownership associations could be created between local communities with less capital.

Social forms of ownership could be established if private and small enterprises became public; their assets and performance could be measured, and they could be open for external capital investment. This could happen by organizing these enterprises into more advanced association forms (joint stock companies, limited liability companies), when all current forms of small private enterprises would be allowed to be transformed into the association forms, and would be open for capital investment of the state and co-operative sector and also for foreign capital investment, and vice versa; they could invest capital in the other organizational forms.

Private small enterprise is an area where the elimination of limits could, on its own, result in dynamic growth, and would assist the spread of the market.

The transformation of some *state-owned assets* into assets of joint stock companies should be considered. By re-organizing some of the large public utility companies (Post Office, State Railways, etc.) into joint stock companies, and selling their shares to any participant in the market with ownership rights, the existing citizen-consumer control can be replaced by direct ownership control.

This means: one, the emergence of management based on long-term interest in increasing capital; two, an increase in resources for development; three, the entrepreneurial, market-oriented transformation of the communal and public utility services.

Organizational decentralization

Increasing the number of participants in the market is absolutely necessary. Attempts made to decentralize in the eighties have not been successful so far: modifying the internal structure of enterprise, establishing internal interest for utilizing foreign capital and introducing self-management forms in a better enterprise atmosphere all failed because the large enterprises were able to defend their own interests and because of the weakened position of the centre *vis-à-vis* the monopolies.

The necessity exists on the other side as well: only a wide circle of enterprises interested in the continuous and uninterrupted development of the market can guarantee that organizational interest does not return to the earlier system, which automatically prevents competition and which has only a slight interest in profit. The increased number of the participants in the market will strengthen the social basis of reform: assisting the interest in and values of independence of units within large enterprises, participation exceeding the role of employee and consumer, and giving equal treatment to the different forms of enterprise, may strengthen the credit and social background of the reform.

Organizational decentralization will modify the interests and possibilities to enforce the interest of economic units, as well as those of the central management and also affect the scope of movement of the latter. The government must work out a programme for organizational modernization in which the methods of decentralization from below and from above are combined.

The first element of this programme should be the supervision of the organizational system of enterprises currently under central control, and the transformation of the non-communal, public utility companies into individual state enterprises, in order to unify the subjects of regulation and their activities. A new government committee should be entrusted with supervision and decision-making. The decisions should be taken individually, but there must be normative criteria for decision-making.

The second element should be the establishment of a cartel office, which would be entrusted with the investigation of monopolies, and, if necessary, with decision-making powers on breaking up monopolies in the period of stabilization—even in the circle of self-managed firms.

The government could use *bankruptcy and economic rehabilitation as a third element* in increasing the number of participants in the market. The budget as creditor could initiate bankruptcy procedures against enterprises in monopoly positions, where it is likely that the reason for bankruptcy is the over-centralization of the enterprise organization. In these cases the budget would only accept a solution resulting from Chamber of Commerce and court sessions that would guarantee the avoidance of bankruptcy due to the company's monopoly position. The budget could also use the means of organizational decentralization in cases of financial rehabilitation of enterprises by the state.

Another way of government initiated organizational decentralization should also be considered: namely breaking up large, horizontally organised enterprises that have a monopoly position in sales, by reorganizing the units of the enterprise on different sites or with different activities into individual state enterprises. (Exceptions could be communal, public utility companies and some others with special production lines.)

The advantage of a centrally managed campaign of organizational decentralization is that it could lead to rapid and overall changes that can be carried out in the same period of time as the transition to new forms of enterprise management. In this way there could be about two to three thousand new state enterprises established, which is sufficient for a break-through toward a new market structure. A further advantage of the decentralization campaign would be that it is normative in essence, based on criteria publicly announced and unified; the chance of subjective, wrong decisions is small, and it does not exclude the possibility of renewed cooperation or even association of the new state enterprises.

The government could also establish *capital agencies* for purchasing, reorganizing, and later selling fixed assets or of whole enterprises or workshops freed by bankruptcy procedure. These sorts of enterprises could be established as affiliates of certain financial institutions, associations or independent state enterprises. In order to assist technical-technological development, the government could initiate the establishment of innovation parks. These could receive a number of new functions and licences as corporations, and the state could contribute to their establishment by providing the necessary infrastructure.

The further development of enterprise affiliates is also necessary. Similarly to the legislation on special groups, a modified legislation concerning affiliates should allow the collective of an enterprise, or its associated workers, or an entrepreneurial special group, to initiate the operation of a state enterprise or a cooperative as affiliates. Full or limited liability of the founding enterprise for the duties of the affiliates should also be made possible.

Changes in legislation should also assist foreign capital to become an organic part of the system of capital allocation in the Hungarian economy and in production by making direct investments. For this: one, the current system of giving licences to joint ventures should be replaced by registration at the Court of Registration; two, the possibility of establishing enterprises with 100 percent foreign ownership should also be created.

The number of participants in the money market needs to be increased in order to boost competition. This could also be assisted by a real *freedom to choose a bank*.

Financial institutions that currently have limited licences only should be able to receive licences as commercial banks. Their future specialization can thus be started from a basis similar to that of the already existing commercial banks, and can develop according to the requirements of the market.

There should be more *investment financing institutions* established by banks, trade union funds and other financial institutions in order to strengthen the role of risk capital, personal investment (by the population at large) and final capital investment. In order to fully break the monopoly position of the OTP (National Savings Bank), the mixture of the functions of social policy and of a financial institution must be eliminated (especially in financing housing); this is a task for the second period of the reform programme.

The government should give direct assistance to the organization of a *stock exchange* in the form of an association of banks.

The government should prepare the *programme of boosting entrepreneurship,* and introduce it preferably as early as from the beginning of 1988. In this the government would support the foundation of small and medium-sized enterprises, independent of the form of their ownership. It would give *infrastructural concessions* (land concessions, technical laboratories under lease, telecommunications, roads and other assistance with transportation, etc.), *financial concessions* (unified tax concessions in the first two-three years of a new enterprise, and even longer in certain activities) and *import quotas* that would be distributed on the basis of tenders between the enterprises.

Political and social preconditions of the economic reform

The state of matters in the economy and the necessity to change it require political, organizational, institutional and social reforms as well. The value of these reforms include the possibility of the public to control the market economy and central actions by the means of publicity, participation, plurality in representation of interests and democracy.

1. The constitutional place of the *party,* a new, economically sound, democratic division of labour regulated by legislation between party, representative and governmental organizations, representatives of interests and public institutions should be established.

The party should work out the guidelines of principle, and should realize them through its members working at governmental organizations, at institutions representing interests and at the press without calling the leaders of these organizations to account on a hierarchical basis. In accordance with the resolutions of the party on principles, party, government and interest representing functions should be separated concerning both organizations and persons. Within the party the proportion of elected and representative bodies should increase at the expense of the administration; the freedom of different trends and platforms should be guaranteed as well as the security of the minority, in order to give space to diverging political and economic political views.

2. *The reform of our system of representation* necessarily follows from the electoral reform. The freedom of members of Parliament, who had their own programme at the election, to set up groups within the Parliament (in addition to or instead of the existing ones) should be granted. Standing orders should be revised and the members of Parliament should have the right of free interpellation. Members of Parliament should be free to engage specialists, so that on the basis of their opinion they could evaluate the proposals of the administration (they should also receive funds for this). Legislation as well as setting the direction and personal conditions of the governmental activity should be concentrated at the Parliament. The substituting role of the Presidential Council should be revised and restricted to technical matters. In order to establish economic constitutionality, the rights of economic units and private persons as actors in the economy should be acknowledged and guaranteed. Everything that is not forbidden or limited by law should automatically be permissible to all economic units and persons. Accordingly, the most important taxes and regulations should only be set and changed by law. Administrative regulation through the use of numerous ordinances for the bombardment of enterprises and citizens should be replaced by contracts and regulation by law. The equality of civil rights should be guaranteed concerning labour law, administrative procedures and administrative law as well.

3. The reform necessitates a stronger and more united *government* than the previous or current one. The government should act as strategic manager, and its tasks should be defined by law. The operation of government committees should be rethought and a new organizational system of government created. By organizing

government tasks along cabinet lines the current dispersion of governmental economic policy by committee could be eliminated. The authority and responsibility of ministers should be rearranged. The government should act on the basis of a unified programme for the realization of which it is responsible to the Parliament. Rather than attempting to replace and simulate the market, central management should be organized with a united, operating market in mind. The main task of the government is the *constant and conscious elimination of the constraints* on the market.

4. All individual members and economic units in the country should have *their interests represented:* the system for this must be based on voluntary membership and organization from below. The possibility of organizing two types of representation of interests should be established: one, public self-governing bodies with organization and fuctions according to separate legislation; two, freely organized associations. Central control of organizations representing interests should not be practiced by the state administration. Their legal supervision should be the responsibility of the courts.

5. The reform must also draw up a consistent programme of *social policy* that includes the values, organizations and methods for assisting the socially disadvantaged groups. The aim of this social policy programme is to diminish the inequality of opportunities, to prevent the situation of the underprivileged from worsening and to solve the problems originating in the contradictions and spread of the market mechanism. (Social policy makers should prepare a detailed programme for this.)

6. The basis of the reform is *an open society*. The media should be regulated by a communications law prepared (or comissioned) by the parliamentary committee set up for the investigation of public matters. The informal way of press management could and should be replaced by specifically legislated rights and duties in information policy. The Information Office of the government should be transformed into the professional organization of information policy of the government. Concerning the press, decision-making rights should be practiced by the founder, who—in most cases—finances the paper from his own resources or income. Communication channels preferred by the government could receive subsidies from the budget.

7. The reform can succeed only as a *movement*. Its starting point should be at the place of employment, with *reform* committees formed on the initiative of the Patriotic People's Front (PPF). Existing and future clubs at universities, educational halls and social organizations should discuss the questions of economic and social reform publicly, in the widest possible circle. The PPF should bring the activities of these committees together, and present their suggestions and views to the State Reform Committee established by the government. For publicity reasons reform fora should also be set up in the mass media.

A possible schedule for preparing the reform

1. The Central Committee of the HSWP should discuss the situation of the economy and its social consequences as early as in 1987. At this meeting the reasons for this situation should be found, and the meeting should—at least principially—commit itself to an overall economic, social and political reform programme. The resolution should:

a. declare as a principle that the party, according to its principles, practice its leading role as a political movement basically through the personal participation of its members rather than intertwined or parallelly with governmental organizations via the organized party administration;

b. call all party members and citizens—considering the serious situation of the country—to support its overall reform programme which accepts and requires criticism.

2. Following the Central Committee meeting, as early as in 1987, the Presidential Council of the People's Republic must convoke Parliament, where the government report on the social and economic situation should be discussed.

The government should commit itself to prepare a new, detailed government programme within a short period of time and submit it to Parliament. This programme should tackle, *inter alia,* the following questions:

a. the establishment of a new system of administration, organization and responsibility (cabinet-type government organization, economic super-ministry, reform committee, revision of government committees, exact and public setting of their authority, establishment of united government responsibility; placing the bank of issue directly under the control of Parliament).

b. increased political and professional participation of the members of Parliament: by changing the standing orders, the right of free interpellation should be extended; the formation of groups within Parliament should be made possible; funding for experts commissioned by the members of Parliament should be secured.

c. the criteria for crisis industries should be set as well as the circle of crisis industries identified together with the institutions and methods for solving their problems. The Parliament should form a committee to control and evaluate the programme managing the crisis industries.

d. genuine parliamentary and national discussion of the large central investment projects involving international commitments (after abolition of the current limits on the dissemination of information). Until the modification of contracts, or the abandoning of certain projects following the analysis and discussions, Parliament should suspend the Hungarian commitment to these large investment projects.

e. the modernization programme for enterprise organization (enterprise control, organizational decentralization).

f. the preparation of forms and time schedule for negotiations between the government and the representatives of interests on wages and employment for reasons of social policy.

g. the exact scenario for preparing, discussing and passing the following new bills;

—new law for budgetary planning and presentation,

—modification of the Act on State Enterprises in order to bring about the conditions for the modernization of organization,

—replacement of the law decree on association by a unified Association Law,

—the settling of the legal and financial position of those temporarily seeking employment (i.e. the unemployed),

—changes in the anti-monopoly regulation, and in the licensing procedure for utilizing direct foreign investment.

h. the preparation of the reform of political organization in cooperation with the Central Committee of the HSWP and PPF.

This reform would, inter alia, deal with the place and role of party organizations in a constitutional framework, as well as with the rules governing the representation of interests and associations and the further development of the electoral system.

This programme and discussions about it should receive wide coverage in the mass media; the conditions and institutional system of publicity should be prepared.

The following cooperated in the preparation of the original study:

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COMMENTS AND CONTRIBUTIONS*

Á. ANGYAL

The most recent success of the Hungarian reform literature is the study "Change and reform". This work, written by social scientists, raised wide-spread interest and emotions, became the topic of unofficial discussions, forced every part of the opposition and of the ruling party—with the exception perhaps of the unusually silent domestic mass media—to take a stand. I decided—upon the request of both the authors and my party—to take the constructive road of expressing my views. Being involved in the current conflicts—if you like, crisis—of the society and economy, I accept the diagnosis and evaluation of "Change and reform". Below, I shall make an attempt to describe which of the solutions I find possible—sometimes agreeing, other times disagreeing with the authors. Since the possibility of making extensive and meticulous suggestions is limited by both length and my knowledge, I shall make some roughly outlined suggestions only.

Before the outline, however, I must speak about the actual notion of reform. I do not consider myself a reformer, although I am for the general direction of the economic policy set in 1966, i.e., commodity and monetary relations, autonomy of the enterprise. But the notion of reform has discredited itself. Nowadays even bureaucrats and retrograd persons consider themselves followers of the reform: there are "carpet", "conservative" and "avantgarde" reformers; everybody tries to sell his views as a reformer. I find it thus more correct not to give any name to the direction. My goal is to find the way of social and economic development (dynamics), because I believe that the position of a country with an increasing lag behind others cannot be improved in any other way. This solution requires changes in the society as well, which, by giving a different interpretation to socialism than earlier and setting more realistic social goals, is after all aiming at social welfare, personal and social success and satisfaction, without the illusion of reaching Canaan.

1. The Hungarian economy operated and achieved results, but its performance has basically stagnated in the past decade. When implementing any sort of changes, I

* Some of the quotations to be found in any of the following comments and contributions were taken from an earlier (longer) version of "Change and reform".

find it very important not to endanger the existing operationality, and that the large systems of commodity supply, public utility services, production and consumption serve the population even in the transitory period, and meet social needs at least on the current level. Our position in the world economy should not worsen, our social achievements should not be given up. Some believe that we have to take a step back before starting to move forward, but nothing proves that this "strategy" is correct. I think that a more realistic and more promising version could be—while maintaining our positions—to concentrate the social and economic reserves in the spheres (mainly on economic performance) where we want to make progress. Cuts in certain industries usually do not release mobile sources that could be utilized rationally for development. Therefore I believe those industries that—according to the current, many times deceptive system of values—seem unnecessary, ready to be eliminated, must not be crushed by administrative measures, but should be left to waste away in the course of social adjustment (in other words with market methods) provided that they cannot stand on their own feet even among the circumstances of sounder economic regulation than the system today.

2. I believe that the economic difficulties can be eased or eliminated by social and economic measures *together*. Maybe the Hungarian economy has a poor ability to adjust, maybe it has an incorrect structure, but an even bigger problem is that the relative performance of the economy is very low considering even individual economic units. Citizens and entrepreneurs achieve much lower performance than they could on the basis of available possibilities.

The ability of Dutch agriculture to adjust is lower than ours. The economic structure of Switzerland is more rigid and older than ours. Yet they are able to achieve better economic results, simply because their performance is higher. Not only the transformation of the economic structure, but increased performance can also lead to good results (naturally, structural adjustment is also necessary).

It is the low work moral originating in the low level of civic discipline, loose technological discipline, uninterestedness in high performance, more or less guaranteed existency independent of honest work, all definitely social phenomena, that are behind the low performance of enterprises. Therefore I believe that the consolidation of the (capacity of the) economy is also a social problem.

3. The current Hungarian economy is burdened with shortages. The precondition for consolidation is the abolishment of these shortages; more precisely, changes are needed in the institutions and economic organizations causing the shortages.

A shortage economy is never normal. Abolishing shortages—by going down to the root of shortages—could be the most efficient reform. In a shortage situation the institutions designed to serve the operation of the economy—mainly the market with any sort of adjective—cannot operate normally. And, if we want to base our social and economic system on a system of values—and I cannot suggest anything better—then there must be markets that assist the prevalence and assertion of this system of values. We simply cannot tolerate permanent shortages, because they disturb the normal economic processes.

4. The deviancies in the economy and society are consequences of the lack of clarity in ideology. The political economy of socialism is weak in its theory. Many aspects of the image of socialism earlier advocated and accepted proved to be idealistic, utopian, or simply impossible to achieve, and therefore false. Many times this lack of clarity in ideology resulted in the wastage of our time and resources on harmful, or just not efficient solutions, social experiments and model building.

The most apparent tail-track of the past few years due to such lack of ideological clarity was the series of economic discussions and actions that approached economic consolidation with the desire to improve the systems of *distribution* of the produced values and goods. This cannot be successful, just like the housing crisis cannot be solved with more sophisticated principles of flat distribution.

In this discussion, I shall not even try to list all the unclarified ideological questions. I shall only make an attempt to contribute to the success with two ideas that I have gained through experience in economic management.

—What is possible in theory and logic is not necessarily viable, a model is not necessarily realistic.

—The same goal can be achieved in many different ways. An enterprise can be successfully managed in a democratic or dictatorial way; one can get rich by one's work or by one's capital. Therefore there is no reason to make one of the ways, methods or means of achieving a given aim compulsory. Ideology should leave a wider zone for flexibility then earlier (now the task is to identify these zones).

5. The economic and social changes will be implemented in an international environment that may be benevolent, but will be willing to make any further sacrifices for the Hungarian consolidation to a small extent only. It is also in our interest to stop utilizing external resources whose efficiency is not satisfactory, because this leads to capital losses. Accordingly, even the maintenance of our external position, more determined economic "openness", re-arrangement and capitalization of external resources must be managed as subordinate, secondary aims in the stabilization process. External relations must assist the establishment of domestic economic balance and consolidation, not only when obtaining credits but also by their whole strategy.

6. I am for indirectly managed economic regulations, based on interests. In the mechanism of this regulation, social needs are identified and met by market mechanisms based on solvency and autonomy. Thus such regulation is needed according to which entrepreneurs—by realizing their interests, rather than by a hierarchy of interests—obtain their profits from production and sales, rather than from administrative spheres. The relationship between entrepreneurs and economic

management should be *monetary,* i.e., they should be connected by correctly functioning channels of taxation (and tax relief).

The perhaps remaining part of *directive* management should be coupled with legal guarantees and such an accountancy system that compensate for the violation of enterprise interests by the directives. (Principles are needed similar, for example, to the case of state expropriation—of land, buildings, etc.—where fair compensation is guaranteed by law.)

7. Central economic management should be more limited. The environment of the enterprise sphere should not interfere directly with its decision-making, and even its indirect impact should be realized only by monetary or compensation methods. The most important task of economic management should be regulating and influencing the market operation of the enterprises. This can best be done by the combined regulation of taxation, incomes and prices. For the sake of these three and their ensemble I shall take a side track.

Tax is the function of basically three economic factors: turnover, capital and profit.

According to the different versions of state tax systems, there is a limit of about 30–40 percent of the GNP where taxation does not yet slow down the normal operation of the economy. Therefore we must aim at a system where a total tax bill of about a third of the GNP satifies the need for resources of the economic functions flowing from the responsibility of the government. Any larger extent of centralization is harmful over-centralization that reduces the autonomy of enterprises, and also their ability to make decisions. (In Hungary, centralization through taxes was about 20–25 percentage points higher than this in 1986; this fact alone explains the lameness of enterprises.)

A special type of tax is negative tax, i.e., subsidy, the practical source of which in the tax-paying sectors is not the central budget, but the net income produced by the enterprises. (Subsidies do not mean the re-allocation of means taxed away from others, but the reduction of normative taxes, the possibility of not paying a part of the due taxes.)

These basic principles of taxation should be applied by simple, clear-cut taxation techniques.

There is no reason to separate the wage funds from other costs, and even less to introduce separate limitations for them. Income regulation, i.e. the limitation of the level or amount of per capita wages increased by taxes, also reduces purchasable performance. Since the main reason for our economic troubles is the limited nature of performance, I consider any elements of regulation that results in this harmful.

The incomes of small private entrepreneurs and incomes from wages should be regulated on the basis of the same principles and to the same extent, acknowledging that a certain level of personal income—we might as well call it subsistance level—is tax free, mainly for social, welfare, and existential reasons. It is logical that the minimal conditions for the operation of small private enterprises should also be considered as items reducing the base of assessment.

Prices are the most important characteristics of a market economy. Separate regulation of prices should only be applied for social or preferential reasons. This can be done, in a narrow circle, by the existing, so-called fixed prices. But even officially fixed prices must guarantee the profit of the producer in order to ensure the prevalence of market and entrepreneurship.

The comparison of domestic and international price levels should be done by exchange rates, customs duties, and other costs burdening imports; therefore there is no need for a separate price formation adjusting prices to the prices in the foreign markets. Some protection of domestic production is, however, necessary.

Regulation concerning the fairness of prices or profit is unnecessary, because it does not make economic sense, it is an ethical category. However, the notion of fairness should be applied to the operation of competition and market.

Thus the revival of the economy can be best assisted by limited taxation of simple techniques, wage setting and income regulation adjusted to actual personal performance, and a price system based on the coordination of market cost relations. The task of economic management is to establish, operate and protect these.

8. A further important task of economic management is the distribution of the centralized resources. Within this, in addition to the general government operations, like meeting the tasks of external relations, domestic affairs, justice, defence, social, health, cultural sectors and infrastructure, the most timely task is the *economic revival,* and increasing the income producing ability of the society. To meet this task, the capital concentrated by the centralized sources (the largest in the country) is available, bank capital can also be used. The direct economic operation of the centre also influences the enterprise sphere. Such operations should boost entrepreneurship and support progressive solutions. The actual central economic operations and assistance must be concentrated on some preferred tasks, and not on influencing the *whole* process. *The centralized resources* therefore should be used not for the operation of the whole economy, but rather for *innovative, progressive programmes that will boost the economy.*

9. In order to establish a well functioning market and competition, economic partners with equal opportunities are needed. For this such legislation and institutional systems are necessary that limit monopolies, protect the actors of the market, and guarantee the equality of partners in a contract. Deals and agreements between the authorities and enterprises must be based on equality before the law (with the exception of legislation itself). Even the rules of procedure should be regulated by equality before the law, i.e. agreement! Actors in the enterprise sphere should not get in

a superior position either by the assistance of the authorities, or by their monopoly position. Superior positions should only be achieved by better economic performance.

10. The normativity of regulation should be defined as well. Mechanisms of taxation and subsidization (and other regulators) not of uniform *extent*, but based on uniform principles, should be operated. Normativity should be the measure reflecting the possibilities of a given enterprise group. These possibilities are related partly to the traditions, professional culture and abilities, including foreign trade abilities, of the enterprise group (the economic branch for example), and partly to the central priorities concerning the importance of supply and participation in a priority programme.

If, for example, we want to assist the development of environmental protection, job rehabilitation, research and development, or electronics, then these activities, wherever they occur, must receive tax concessions. Since the Hungarian economy is over-centralized (and no administrative steps can—without serious damage—change this situation), decentralization and the foundation of new enterprises should be assisted by preferences (as there are examples for this already).

11. The treatment of special and exceptional cases and situations must be settled as well. The government, ministries and governmental committees already have licences to solve individual cases now, but their method is wearisome and the procedure lengthy. The government must be prepared for the exceptions, must determine the related principles and must receive the authority to handle them. Those concerned should also play a role in the exceptional procedure as well, thus this procedure must be the implementation of a regulated programme outlining the possibilities and consequences, rather than an administrative procedure by the authorities.

12. Those aware of the economic difficulties may suggest that, in order to solve the current problems, special economic methods should be introduced for a short period—for example, for three or five years. In this period—let us call it consolidation or crisis-treatment—the proportion of central measures would increase, some sort of "martial law in management" would be needed. I believe that this would be the wrong solution, because it is built on the incorrect assumption that it is quicker and more efficient to find solutions with administrative methods than by introducing a system of interests and market relations. However, economic management must, in fact, change in the near future, *the introduction of regulations boosting the economy must be accelerated:* for example, of income and price regulating measures and the abolition or modification of measures resulting in shortages. If these processes can be successfully accelerated, the conditions of a consolidated economy can be established as well. Until then, the government must guard the correct proportions of production, accumulation and consumption with its existing means, and must prevent overconsumption. The ways of doing so are numerous, raising consumer prices and limiting investment resources is only one (and not even the best) of them.

13. We must mention the methods of economic regulation, too. I consider those

solutions correct when the enterprise sphere can do everything—with a few, very rare exceptions—to increase its income, and the state grants favours for the achievement of the centrally preferred goals. Prohibition, sanction and penalty as means of regulation are neither attractive nor efficient. Therefore not the philosophy of monetary *restriction* but that of monetary *preferences* should be implemented, while increasing the normal level of taxes can only happen as an exception.

14. The engine of higher economic performance is the skilled, best possible qualified intelligentsia. While observing the principle of equal social opportunity for everyone, and equality before the law, the income—and even wages—of these strata should be made attractive as soon as possible, in order that more people choose the way of living of an intellectual. Therefore the codified earnings norms and classification of jobs should be significantly raised concerning intellectuals and those with higher qualifications, and obtaining qualifications should be supported by subsidies.

For the period of study credits should be introduced to cover living costs that could be repaid with work, and also tax concessions, bonuses etc. should be implemented. In personal taxation the additional costs of intellectual existence, costs of education and training should be deductible from the tax base.

15. Of all the activities financed by the government, primary education* needs the most support. The administration of education must achieve the availability of citizens with up-to-date skills at the end of the period of primary education for work in the society. This is more important than any other of our cultural policy goals, and is naturally related to the increased advantages connected with study and to the improvement of the situation of teachers.

16. The economy-rooted crisis having the most wide-spread impact on the society, is the shortage of housing. Central flat-building programmes must be organized, taxes on flat-building must be significantly reduced, the chances of the population to obtain (not freely, though) a flat must be increased. Learning from the failure of the long-term flat-building programmes, better prepared new ones must be organized, because the conservation of the way of life without the most basic conditions for living is intolerable. There is no time for any strut or ranking, the number one programme of the building industry must be flat-building.

17. In addition to the social activation of pensioners, and the additional utilization of their willingness and ability to work, the two preconditions of social self-sufficiency are the guaranteed minimum existence and the maintenance of the real value of pensions. The first one requires social, child-care and labour-safety programmes as well, while the second calls for the separation of the pension fund from the rest of the budget.

* Now extending to eight years in Hungary. — Ed. note.

Capitalization of pensions, shifting them as capital into the enterprise sphere and paying the returns on the capital as pensions is a better and more realistic guarantee for the stable real value of pensions than maintaining the value of resources channelled to the budget. The role of the government in the pension mechanism should be giving additional guarantees and setting the principles of handling the pensions. Pension funds cannot be a source of budgetary revenue, and they should not be given this task.

18. One of the weakest points of the social "rules" is the lack of clarity concerning the relations between the central administration and the citizens. One issue of this is the bureaucracy that is created by the apparent power position of the administration. The separation of decision-making from execution breeds, on its own, bureaucracy. The overly sophisticated ways of procedure, extensive administrative staff—directly or indirectly financed from the budget—processes well protected by legal and administrative instruments and over-regulation itself are self-reproducing sources of social troubles. Their elimination can be hoped from—in addition to legal guarantees—the possibility of calling officials to account, control of appointed bodies by elected ones, and the introduction of simplified, one-step procedures.

Probably the largest social loss is caused by bureaucracy. Therefore the set-up, operation, authority, size and organization of the administrative machinery should be investigated in the framework of an organized programme, with the definite intention of reducing bureaucracy. Within this the general practice of separating decision-making from execution should be stopped. Decision-making rights should gradually go to elected bodies, leaving the task of preparation of decision-making and organization of execution with the administration. This should be so in the central government administration, local municipalities, mass organizations and other administrative type activities as well.

19. A general process of democratization is needed, in which the strengthening of the above mentioned social decision-making and control mechanisms is one feature, and the other is the spread of licences for the organized safeguarding of interests. Organizations representing interests must also receive the right to *realize their interests* in addition to coordinating and making clash interests. This would mean the extension of the right of veto as well as active participation in decision-making. This participation, however, should be voluntary; the way of realizing their interest should be chosen by those concerned. Those representing someone's interest should not be allowed to set conditions to those commissioning them, because this would lead to separate administration.

20. The process of democratization requires changes in legal policy as well. In the framework of these changes corporate rights and the right to represent one's interest should be acknowledged, while administrative and procedural rights should be limited and personal and official (hierarchical) rights determined. Equal chances, equal

starting positions in competition, and partner relations should be secured as institutionalized guarantees of democracy.

21. The attitude of ideology, economy and society to property must be settled, as well as ownership licences and interests. Within the capital and wealth functions of property the increase of capital, i.e. ways of increasing wealth and property must be separated, and included in economic regulation.

22. Social and economic planning must receive a new role. The plan should be the system of goals and means rather than of compulsory indicators. Operative and strategic planning should manifest itself in social and economic action and in the main direction of structural changes and indices for dynamics. The plan should not be a compulsory measure that can be called to account, but orientation for action. The main task of the plan is not measuring but boosting social actions.

23. Employment policy must be based on the equality before the law of employer and employee. The employer should be able to get rid of his unwanted employees just like the employee is able to look for a different job. In the labour market too, automatisms and the balance of demand and supply should dominate. This can only be achieved if the price of labour power is regulated by living expenses, work performance and the resources available to the employer (i.e. how much the particular labour is worth to him). At the same time, social policy must be prepared to support those who, despite their will, cannot find jobs, on the minimum level of existence. One's attitude to work should only influence his civic freedom in the case of legal offence.

24. The budget should play a smaller role in financing culture, sports and leisure. Financing secondary performance should not be a central governmental task; this should be done by sponsors and patrons, or they should be organized as non-profit, lucrative self-financing institutions. Concerning the health service, in addition to free basic services, high quality services for payment or covered by special insurance policies should also exist. Only research activities attached to central programmes by scientific workshops or educational institutions should be financed from central resources.

25. Distribution and allocation mechanisms of resources for local, infrastructural, regional policy purposes should be replaced by resources originating from taxes paid by local taxpayers. Instead of centralization, the role of taxation proportionate to territory and functions should be strengthened. The operation of local power and administrative organizations, and within that the handling of financial matters, should be placed under social control. Actions with significant financial consequences should be approved individually as well, not only as parts of the annual programme. The highest forum of popular representation and legislation—the Parliament—should also practice stricter control than the discussion of the budget once a year now, over the sources, distribution and handling of central money.

This outline, naturally, does not cover all necessary changes. My remarks and suggestions mainly reflect industrial problems. However, I am certain that similar initiatives can be collected concerning the whole economy and society. This work was inspired by "Change and reform", the further development of which, along with the announcement and implementation of a dynamic social programme, should be ensured by the leadership of the country.

M. BUZA

My *first* impression is that this study was *inspired by worries for the future and by sense of responsibility*. The authors and the "commissioning" Patriotic People's Front deserve credit for their efforts to find the way out of the increasingly severe economic crisis. Their joint effort proves to me that the cultural, ideological and political crises developing among the circumstances of deepening economic crisis do not necessarily lead to the crisis of intellect. The increasing difficulties even urge us—by strengthening the sense of danger—to find the way out. While there are "cultivated minds" available to prepare similar concepts, while there is a way to have honest discussions on similar studies, there is no reason for pessimism or despair over the lack of prospects. The fact that this study could be prepared under the People's Front organization in the eighties, and that it has been published rather than being forced to spread in samizdat form, and that the Economic Panel of the Central Committee also discussed it, is significant on its own. My first impression is honest *respect* for the high professional standard and for the political courage of the authors.

The second emotion is raised by the *dramatic* effect of the study. The evaluation of the economic and social situation (*Chapter I*)* is not a simple diagnosis: but rather some sort of *economic and social pathology*—not because the study supplies extraordinary information, although there is such in it, too. The real *shock* is caused by the way in which the authors organized our most serious problems in a bunch. All the problems are well-known individually; official evaluations do not try to hide them either. Yet collected together they take on a *different quality* that has the message: we did something *basically* wrong. This conclusion is not challenged by the fact that certain statements in the study are questionable, unproved, or unprovable. (Thus, for example statements like: "there is a crisis of confidence between enterprises and the central management", or "there are not more extra goods or extra income left in this stagnating economy".) The crisis of confidence is no doubt *apparent,* but it is hard to tell in what circle it exists and how intense it is. *It seems* that the government is not able to manage in the old way, but there are still many signs of the tolerance of those

* These remarks concern the longer (75 pages) study, prepared prior to the discussion of the Economic Panel of the CC of the HSWP. Also the quotations were taken from that version. (Ed. note)

managed, and that they are still willing to live in the old way. We do not know yet where is the threshold of sensitiveness.

Following the introduction and *Chapter I*, raising great expectations and reading *Chapter II* (overall economic reform), offering an outline of therapy, I was left with a *mixed impression:* one, because of professional reasons, two, because of social, political and ideological interrelations, and three, because of certain inconsistencies. The ideology apparent behind this reform concept reminds me of the neo-conservatism rooted in the Smithian school of thought. My main problem with the concept is not that it concentrates on the monetization of the economy and on reducing the role of the state in the economy. My doubts concern mainly the *redeeming* position given to the market and how the authors offer it as a universal medicine. They know themselves (they refer to it) that every medicine has unpleasant side-effects. There are medicines that the ill person cannot take, because it causes more harm than good.

The picture given about market socialism in *Chapter II* is *one-sided* and, on the basis of "double or quits", even this picture is painted in a more frightening manner through excessive radicalism.

In my view, the role of market ideologies among our conditions should be revised. Nowadays—when restructuring the economy is our most important concern—this became a basic question. The question to discuss is not whether there is a market or not. *The real question is that large-scale structural changes can only be implemented on the basis of a strategy well founded by the economic policy.* The capitalist state always interferes in the interest of the total capital, if necessary against the individual capitalists. It could be useful to consider the impact of "adjustment" policies aiming at balancing of the balance of payments in some Latin-American countries of medium economic development level like us (Argentina and Chile, for example). The monetarist strategy and tactics of economic policy in these countries led to deepening economic, social and political contradictions in the seventies and eighties. As a consequence of liberalizing the commodity market, the economies of Argentina and Chile were "de-industrialized"; falling production was accompanied with diminishing employment. Holding back the monetarist expansion narrowed the domestic market, increased the proportion of unutilized capacities and increased the tension as well.

On the basis of a clear-cut state strategy we can choose between the *means:* the state can nationalize or re-privatize, cut or extend social and education expenses. If the central economic strategy is clear-cut and unambiguous, the division of labour can be adjusted to that, clear bargaining positions can be established for example between state and trade unions, or other institutions representing interests. But the restructuring of the economy can only be carried out on the basis of the state strategy of economic policy; an important element of this strategy is the establishment of autonomous political structures; the political reform, and its precondition is the functioning of the market as a means. To trust the market with the restructuring of the economy at a time when there is economic crisis on the one hand, and the calculation of efficiency is not reliable on the other, is especially risky. This is why the bargaining positions are not clear, the market ideology on its own cannot help this.

Everything that is written in the study about political and institutional reform is correct. But we must see that the market ideology hides the similar danger of one-sidedness. We cannot expect the market to help overcome problems arising from the unclear bargaining positions (dependence of enterprises on the central administration, constant re-arrangement following decentralization, lobbies, etc.). It is the autonomy and clear, differentiated bargaining position of the institutions representing interests that will solve the problems. When this is settled politically, we will have established the basic precondition for the operation of market mechanisms. Clear strategy and the unambiguous determination of the priorities of economic and social policy are necessary preconditions for this.

The authors demand "open self-criticism" of the government, which is right, because the government, with the introduction of the latest half-measures (measures protecting working time, the freezing of wages, procrastination about the pension system), is about to loose its remaining authority. However, since "the party and government have remained intertwined" *it is not enough* if the government exercises self-criticism; the same should be done by the highest leadership of the party. And here we arrive at a basic question: can the ruling party realistically be imagined "in sackcloth and ashes", and can it be expected to take responsibility for its deeds? Should it perhaps also acknowledge that it is not suitable for the leading role? Should it also give up its missionary zeal, and *the power* that has always been the number one priority for communist parties? This is out of question!

According to the authors the main reason for the present situation is that we deviated from the resolution of the CC taken in 1966. Emphasizing continuity does not mean anything (since this is what the official ideology does as well), or it means that everything that differs from this resolution is a reason for the present situation. The authors simply lay down a smokescreen here, we can suspect rather then understand what they want to say. They say economic policy but mean politics; they say government but mean political leadership. One can suggest self-criticism only if one also indicates who should exercise it and about what. The paradoxical situation, when everybody agrees in the diagnosis, shows exactly that the formal demand of self-criticism does not lead anywhere, since "everybody, on every level" emphasizes that "almost everything" is in crisis. Thus there can be a consent achieved not only in the optimism of the success-propaganda, but also in the pessimism of the crisis-propaganda. But in this way self-criticism becomes elusive and will finally lead only to "the government starting a dialogue with the society"; i.e., it will have a good cry on the shoulders of the society. If we really want to return to the reform concept of the sixties, then:

—it should be declared that the reform is a political reform that has a system of means in economic policy;

—it should be investigated why the political reform was left out of the goals in 1968, at the time of the introduction of the reform;

—it should be investigated what sort of social and cultural conditions the reform goal assumed in the sixties had, whether these conditions were investigated at that time (mass support, training, education, structural problems of the Hungarian economy, social stratification and reproduction, etc.).

Only if we analyze the Hungarian reform process critically can the reform resolution of 1966 be chosen as a starting point. Without this, "return" to 1966 only remains a declaration, and can only have an ideological, and through this a political function.

According to the study, the most important goal is to establish an economic structure that is efficient in the world market—with government participation and with foreign money. But we do not even have a development or a reduction programme. We have no idea what the world market will be like in ten years' time, and how much it will pay for its needs. We are supposed to know the future prices of the world market right now! There is no central economic management which could do this.

We shall probably have to give up the priority of selective development, and replace it with attempts to establish proportionate development including proportionate capacities, products and product development. The so-called export-oriented development deforms the structure of the economy, and reduces its ability to produce income. Forcing exports and the selective investment policy take all the money away from small investment projects which have a high rate of return, mainly from the replacement investments. The priority, preferred activity will be left hanging in the air if the development of the preceding phases is postponed.

The massive stimulation of exports hurts exports and the supply of exporting enterprises with the means of production because, among such conditions, enterprises are not very keen on delivering goods to each other. The under-development of the background industry and, generally, of the domestic vertical production integration results in the vulnerability and thus in the excessive dependence of the production structure; in the intermediate phases of production the rate of indispensable imports increases. Also materials and spare parts necessary for the operation of the machinery and equipment imported from capitalist countries can only be bought from capitalist countries.

The VAT and personal income tax planned to be introduced as early as next year will induce—unfortunately—unforeseeable restructuring of incomes, changes in the price system and price level that the centre will not be able to handle. I have my doubts concerning the ability of the society to tolerate such a significant shock. Therefore I still believe that the two should not be introduced together.

Concerning the introduction of significant steps in structural policy I think we should wait until the new tax and price system will have full effect, as nowadays most enterprises are unprofitable because a high proportion of their prices reflect taxes. It may also happen that what is profitable today will be loss-making activity in three years' time, and vice versa. It is also possible that one phase of production is unprofitable but all the phases together are not.

We must join the international division of labour in a way that does not too much reduce our possibilities to make decisions concerning the economic policy, and does not increase our risks to a frightening extent. We do not need export orientation that, via forcing exports significantly exceeding our raw material and energy demand, reduces the national income in real terms and increases the domestic shortage of goods.

We cannot give up the production of cheap mass products by saying that the demand for them can be met more cheaply by imports from developing countries. We produce the additional foreign currency needed for the imports very expensively; marginally calculating—for example 100 forints per dollar—the "cheap" foreign product is much more expensive than the domestic one. The production of cheap mass products utilizes existing capacities and shares overhead expenses; it eases the increasing employment difficulties and can be done easily in relatively small settlements as well.

An important precondition for modernizing the production structure is to maintain our competitiveness in the world market not only formally—by subsidizing *exports*—but by assisting *technological development*. Whatever amount was saved when financing development, was used for financing the deficit. Not the producers of exports at the cost of 100 forints per dollar should be subsidized, but those who produce exports at 30 forints per dollar.

Giving priority to the development of branches producing end-products would involve varied short-term damage, for example

—underutilization of capacities and wasteful use of capital due to the disturbances in cooperation:

—*ad hoc* imports substituting for the commodities in shortage;

—bottlenecks emerging in different phases of production due to the shortage of material, spare-parts and labour, and to the low profitability of producing spare-parts and other semi-finished products.

According to the study, the limits to domestic consumption as well as restriction and stagnation should be maintained. But the level of enterprise investment cannot decrease any further. The standard of living is becoming lower and price-rises are accelerating. Such a solution would be very simple, yet would lead to extreme catastrophe! Cutting domestic purchasing power requires a deflationary economic policy everywhere (creating and maintaining a shortage of money) that will necessarily accelerate inflation because

—it lacks stimulation thus leading to poor performance;

—it will lead to commodity shortages and difficulties in supply;

—excessive taxation forces the enterprises to raise their prices greatly and continuously;

—the extra profit taxed away, created at the enterprises in production and product development, due to entrepreneurial risk or business cycles, will loose its ability to transform itself into capital from the moment it is collected; it will become quota, resource, or subsidy, and will not earn money any more.

Cutting domestic purchasing power would also require an inflationary price policy that would necessarily increase the number of those living below minimum subsistence and would consequently increase the social policy burden of the society.

Cutting domestic purchasing power would have an adverse effect on production as well, since the thus freed goods and capacities will not automatically turn into commodities or capacities for exports against convertible currency. Orders for the products of the enterprises will decrease, overhead expenses per unit will, in turn, increase and competitiveness in prices deteriorate. In this way there will be no increased saving from the national income and the sacrifice of the people will remain fruitless.

The study does not promise the cut in the burden of the enterprises to an extent that would increase the real value of the interest fund. Yet this could be the decisive factor.

Maintaining the current practice of limiting the chances of enterprises to make profits to the extent the chances of the national economy to earn income are becoming limited, will lead to the total bankruptcy of the economy. *Only the enterprises can get the country out of trouble.*

The enterprises have reached the lowest point of functioning ability. The good companies are paying out 80–85 percent of their profits to the budget. In order to avoid the deficit of the interest fund, enterprises must achieve at least 20 percent profit on their capital. In the tax reform the tax burden of the productive sphere should be cut in a way that will result in the increase of the interest fund of the enterprises. Enterprises should reach a financial position where they can withstand certain fluctuations, i.e. a certain share of their income should be freely disposable. The current situation when any unfavourable change can question the ability of the enterprises to function, because all their funds are spent in advance, should be discontinued.

Regulations concerning the profitability of firms relative to capital and wages—that can only exceptionally be met should be eased considerably. Taxing the after-tax-profit (interest fund from profit) again should be stopped. At least replacement investment should become tax-free.

A medium-efficient enterprise should be able to have enough money for flexible adjustment to the market and for being self-sufficient at least in maintaining its level of activity dynamically. There must be guarantees given concerning the autonomy of enterprises. They also must receive legal protection from the interference of the authorities.

The study—in a fair way—describes the negative consequences of the suggested programme as well. It is an *inadmissible superficiality,* though, to stop at the statement that "in the medium-term we must accept not only structural, but real unemployment". This is a fundamental social, political and ideological question. If we accept this, then we shall also have to decide what to call ourselves, since in fact full employment is the last "achievement" that remained from the one-time image of socialism. We can regret the authors did not spend more time on this problem, especially when we compare the reticence on this topic with the meticulous suggestions concerning the restrictive financial policy, tax reform and the new role of central management. This is why the structure of this chapter is *uneven:* important questions are treated superficially (other than unemployment, for example, the questions of ownership and, related to that, of exploitation), while matters that are only secondary to these are carefully elaborated.

I had the most doubts when reading the chapter "Economic reform—social reform" of the study. My soul was split in three: one agreed, one would approach the problem in a different way, and one "conservative", anxious for the system.

I agree that the party should be the vehicle of reform. The function of the party in integrating and harmonizing interests should be strengthened. The political mechanism should be reformed: the division of functions and responsibility between party, government and trade union should be made distinctive. The political system should be made capable of functioning and its functioning should be made clear and unambiguous for the people.

Perhaps consciously, perhaps heedlessly, the authors give up the principle of *democratic centralism!* But a party abandoning it can hardly be called a communist (Bolshevik) party any more. I think the role of the *Parliament* is exaggerated. Or is this perhaps inconsistency again? Are they suggesting the necessity of a multi-party system? They do not say this, but they do say that "trade unions should become clearly the representatives of interests and not organizations designed to improve the quality of work". This means not only giving up the "dual function", and breaking the line of transmission, but—indirectly—also that the trade unions should get out of the power structure, of their owner role, and become independent of the party.

The suggestion of the authors concerning the creation of reform committees at the work places by the Patriotic People's Front, is also related to this topic. I find it unnecessary to create such committees. Winning the employees for the cause of reform is not a matter of new organizations or committees. The precondition for the support of the working masses is a clear, understandable programme. One more organization within the enterprise—in addition to the party, trade union, Communist Youth Organization and others—would be a waste of time and money. Concerning the statement of the study about the working style of the Council of Ministers—i.e. that it is inefficient—I agree. Many of us and for a long time have been saying that we need a political government, where the members of the Council of Ministers are first of all members of the government, and only in a secondary role are they responsible for certain fields. The political standpoint of the Council of Ministers must be transmitted to the ministries, not only the views of the ministries emphasized in the government.

I do not agree with some of the ideas of the authors concerning the media and the press.

I am afraid of the free foundation of newspapers, although it would not hurt having a weekly in which "those with different views" could express their opinions. Concerning the freedom of the press we have an easy task, since the different views have received considerable publicity for years now—even in the party press and by its books publisher.

I am afraid of total self-criticism, because we once had something like that. I do not agree with the necessity of reaching conclusions concerning the personnel, because I believe that the same people are capable of identifying and carrying out a better concept. Maybe a completely new government is needed, but I am afraid that it will not be any better than the existing one. I am not sure that scientists, research fellows, officials, not in position so far could do a better job in government responsibilities than the experienced politicians now in office. One thing is for sure: the current administrative staff of the ministries will have to remain, because without them implementing the major changes in an organized and professional way is impossible. It is the party centre first of all, where a "think-tank" should be created in order to decide on the further steps of the reform. While the party cannot say yes or no, we shall not be able to get out of trouble.

I believe that *the organizations representing interests, first of all the trade unions, should get a larger role in preparing and implementing—before the actual decisions—the further steps.* I do not understand why the trade unions are not asked to make suggestions concerning the way of further development. Similarly, I do not understand why they are not allowed to publish their standpoints, if those are different from the views of the government. The masses are only willing to accept a trade union that has its own face. Having strong, respected trade unions is a fundamental interest of the party!

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In summary, I must emphasize that I consider the initiative of the Patriotic People's Front extremely important, timely, far-reaching and useful. Despite its illusions, there is no doubt about the constructiveness of the study and about the intention to improve the situation. *In fact, one chapter is missing.* It is the one in which the authors could have thought about the reality (here and now) of their suggestions. Because it would mean taking a really big risk accepting their programme. The only way of behaviour that carries an even bigger risk is to close our ears to their suggestions. We can get some support in our decisions to take more daring steps from the fresh Eastern wind coming from the Soviet Union.

Thus far, we have only obtained the knowledge of grasping and maintaining power. Now we must prove that we can manage the economy among difficult circumstances as well, because today this is the main precondition of maintaining the power.

ZS. FERGE

In agreement with others I also believe that the very existence of this study is of major significance. The dramatic analysis of the situation and the suggestions searching for a responsible way out, are food for thought and call for action; this challenge cannot be left unanswered. These statements are true even though several questions remain open, or even if I cannot agree with certain aspects of the study's approach. This is a fresh and courageous venture, and it is very good for possible future action that it has became available to the public.

Concerning the content, I agree with the authors on many points. To reconstruct (or construct) a sound economy is a matter of life and death. For this radical changes are needed simultaneously in politics and in societal and economic matters. Honestly accepting market mechanisms in the economy is a key problem. Without adjusting to the market forces and to the rational efficiency requirements, constant economic stagnation is unavoidable and so is the increase in the lag between Hungary and the international main stream entailing serious consequences for the standard of living and for social policy. I also agree that there can be no consistent reform without the wide-spread cooperation and participation of citizens. The precondition for this is a well-informed public: institutions which render possible the expression, representation, confrontation and conciliation of various interests; and social participation in, and public control of all institutions. Widening of the personal and public autonomy may help in the mobilization of social resources. This is also the precondition for the citizens and their communities to identify themselves with the new economic and social processes, in which, in this way, they will not be passive victims but participants. Naturally, for more autonomous action legal guarantees are needed which assure long-term security concerning both economic (e.g. entrepreneurial) and social action.

"Change and reform" is, in essence, an economic programme. I find it important both ideologically and politically, however, that the authors are aware that consistent economic reform cannot be carried out without changes in the system of political institutions on the one hand. On the other hand, the idea that there are conflicts rooted in the economy that cannot be solved within the economy, and that there are social goals that cannot be approached with economic mechanisms only, is expressed several times in the study. Thus the need for a societal and socio-political programme emerges explicitly.*

The research on societal and social policy has started about ten years ago in Hungary. In the framework of a national research programme, a conceptual framework for long-term development was prepared in 1985. Several important elements of this programme were endorsed by the government. However, in the meantime, economic difficulties have given rise to social problems requiring immediate treatment. Therefore the long-term programme has not been made public, and the long-term targets seem to have been taken off the political agenda. Urgent actions may however contradict long-term goals and may distort them. It seems, therefore, timely to reopen the debate about the basic issues of societal and social policy. Obviously, the former documents have to be updated, especially by spelling out the social requirements of a—hopefully—brief period of crisis, and the considerations relating to long-term thinking and processes. (Incidentally, the economic reform programme would also gain by separating these two types of action.)

As a matter of fact, the revision of the 1985 proposals has already started. A new variant, "Suggestions for the short- and long-term programme of social policy" was prepared for the Council of Societal Policy of the Patriotic People's Front. Following an attempt to clarify the relation between economy and social policy, I shall summarize the most important aspects of this document in order to illustrate the difference between this approach and that of "Change and reform".

"Change and reform" assigns the function of handling the sharpening conflicts which arise in the wake of the restructuring of the economy to social policy. This role is discussed in different contexts.

I fully agree with the desirable objectives described in the chapter on the characteristics of the reform as developed in Section 4**, i.e. that it should be general, radical, democratic and decentralizing. However, I have doubts about the attainment of these objectives because of the over-estimation of the market and also because no distinction is made between legal (political) and market rights. According to the wording of the study the reform should be *"market-oriented;* this includes the elimination of the interference of political and governmental organizations hindering the operation of the *self-regulating market in a constitutionally guaranteed way:* legal

* Societal policy is a larger concept than social policy. It encompasses social objectives relating not only to distributional issues but the processes of social reproduction in general, including work-related issues and the quality of human and social relations in general. [1]

** The authoress refers here, and in other places, to the longer version.

relations should be established between the actors in the economy, based on public contract, reliable and controllable central regulation and, finally, on the *freedom of citizens to choose between market and non-market institutions,* these are complementary features, in the absence of which the establishment of realistic market relations is not possible."

A subsequent chapter deals with the "Political and social preconditions of the economic reform". Again I agree with it on several points, among others with the need to re-define the division of labour between the party, the government, the organizations representing various interests and the public. However, I find it disturbing that the issues concerning social objectives, or developmental trends are blurred as is the role of societal policy within this system. According to the text, (Section 5) "the reform must also prepare a consistent programme of *societal policy* which should describe the values, organizations and methods by means of which the market, the state and society should handle socially disadvantaged groups. The aim of the programme is to *diminish the inequality of opportunities, to prevent the situation of the underprivileged from worsening,* and to solve the problems originating in the contradictions and spread of market mechanisms. (Social policy experts should prepare a detailed programme for this.)" (My italics.)

These quotations as well as other ideas referring to the increasing future role of the market delineate a social policy which would be consistent with "Change and reform". Essentially, this would be a mainly corrective social policy, subordinate to the economy, without any autonomy whatsoever. Its main task would be to alleviate hardships and problems caused mainly by the market, such as unemployment or poverty. Its most ambitious endeavour would be the "diminution of the inequality of opportunities". This is, however, a rather limited objective, since it would leave the conditions and mechanisms creating and constantly *reproducing* the physical and social inequalities of life chances intact.

According to this approach, the dominant sphere of the society is the self-regulating market, its rules and values being the determinant ones. There may exist non-market institutions as well. Yet, only in addition to market institutions of similar functions (otherwise the citizens would not have "the freedom of choice").

I disagree with this approach on societal and social policy and, consequently, with the market conception of the study. It is just as important (I believe) to have a strong, autonomous *non-market sphere* with "sui generis" values, as it is to have a strong, autonomous *market sphere* functioning according to its own values and logic. It might be more exact to say that both a sphere functioning according to pure economic rationality and an other one operating according to a wider "social" rationality are needed. Both would meet needs but according to different principles and values.

The borderline between spheres operating according to a "market" or a "non-market" logic changes with time. It cannot be defined once and forever. The past one-hundred years of European history shows that the non-market sphere—which includes social security, health service, education, certain aspects of housing and other human services—increased continuously owing to the pressure of various social forces. No doubt, in the socialist countries the development of the non-market sphere was dictated from above. Consequently, it lacked inner dynamics and autonomy just like the economy managed from above. In the industrially developed countries—especially where the influence of social democrats or the workers' movement was strong and lasting, and where new social demands could surface relatively freely, changes have been spectacular. The above mentioned traditional areas of social policy often attained a much higher level than in Hungary. Alongside with them, at least in some countries, full employment and more humane work conditions, as well as the protection of the environment have been accepted as conditions limiting the operation of the market even if they may sometimes "hurt" the economy. In the last ten years the "welfare state" has shown signs of uncertainty or even withdrawal. According to some explanations, the reasons are basically economic, while others look mainly for social and ideological explanations. The official reasons for justifying cuts include mainly lack of resources, the spoiling effect of the welfare system, reduced international competitiveness and excessive bureaucracy. While all this is true to some extent, it may not be the whole truth. The reactions against the new tendencies have been, however, rather weak for a while. This may be because the changes were unexpected for most of the citizens—and even for the ideologists of the welfare state, so that they were unprepared to argue and to protect the real achievements.

Recently this situation has started to change again. In some countries views are spreading that the non-market sphere should not be abolished or restricted, but preserved in a renewed form. The essence of change is that bureaucracies and hierarchies must be reduced, and citizens' participation in, as well as the autonomy and flexibility of, the welfare system must be increased. In this logic it is not "free" education, i.e., education financed from the budget and free for the users which ought to be abolished, but the way in which it is operated and which makes students and parents vulnerable. Or, to take another example, the universal network of social security should not be destroyed, but its democratic character strengthened. While there are such tendencies in some countries, in others (for example, in the UK) the tendencies of enforced marketization and of the limitation of welfare rights remain strong.

As is well known by now, in Hungary both the economic and the social spheres were dominated by politics, and social interests were to be realized mainly through the economy. Perhaps the most significant result of this close relation between economic and social policy was the abolition of mass poverty by the means of changing ownership relations and rapidly increasing employment. At the same time, many negative tendencies appeared as a consequence of this type of development, and not only in the economy. Management from above distorted the functioning of both spheres. In addition, social policy suffered from the extreme lack of resources, because the losses of the non-market type economy wasted a lot of money.

As a consequence, in our non-market supply systems—education, health service—"under-financing", excessive bureaucracy, cold and distant hierarchies co-exist with the lack of citizens' participation, entailing a high vulnerability of the clients.

"Change and reform" suggests that by including at least parts of these systems in the market mechanisms, the "free" choice between market and non-market systems will solve these problems. In fact, the current negative features of the non-market system cannot and will not change as a result of this step, while the whole welfare system could profit from the very same conditions which would improve the (market-like) operation of the economy, such as strengthening autonomies, guaranteeing rights, democratizing institutions. The chances of social policy would especially increase if the societal and social interests could be organized so as to better influence the allocation of resources. Incidentally, in the long run at least this would be useful for the economy as well. An advanced economy with a high technological level requires healthy, well qualified labour living among civilized conditions—and this question has never been solved well by the market. (This is exactly the reason why modern social policy has become necessary in the first place.) Let us add that society as a whole would lose if there is no more room for the main "special" values of social policy, humanity, tolerance, solidarity, the reduction of inequalities threatening the integration of the society. All these are human and social values which cannot well be expressed in money terms.

The social policy programme mentioned above accepts for the near future that the redress of the economy is high priority and that this requests compromises from societal and social policy. However, it still considers it important that emergency measures should not trigger lasting trends which would hamper the return to "desirable" tendencies when demand for these will emerge. It also emphasises that, in spite of shortage of money, some new elements ought to be introduced in social policy.

The main points of the short-term (emergency) programme are:

—to ensure the minimum standard of living *as of right* in the case of groups "in need" (unemployed, large families, those unable to handle the increasing costs of housing, etc.). This should replace the existing out-of-date, often humiliating system of assistance. One may add that a normative system is in better harmony with the logic of the market than the current highly discretionary and therefore arbitrary system of decision-making. The most urgent step in this direction is the introduction of unemployment benefits for all concerned;

—to protect low salaries and social security provisions. In order to do so, the programme suggests—in addition to indexation and occasional compensations—the postponement of the introduction of at least the system of personal taxation and the maintenance of the progressive social security contribution (which assures better the funding of the social security system, is cheaper etc.);

—to protect jobs. This means on the one hand that the abolition of jobs should be pursued less relentlessly in the non-competitive spheres, and, on the other, that the creation of individual and collective workplaces should be supported in various ways. In addition, new training forms should be introduced in the coming years, to assure at least "parking places" for the young generations;

—to create an organ for the direction and coordination of social policy (that is now more needed than ever before);

—to organize various types of training and education in the field of social policy and social services.

The basis for the *long-term* prospects is the cooperation of social policy and economic policy, with the relative autonomy of market and non-market spheres. Accordingly, institutional systems and conditions of social policy should be created with the consent and participation of the citizens which allow the special values of social policy to prevail.

To sum up, the long-term development of social policy should be organized around four elements:

1. Cooperation with the economy so as to *prevent* some social problems which cannot be effectively treated in an *ex post* way, such as e.g. unemployment, impact of hazardous jobs.

2. The development of the social security system so that it should in fact provide income security. The traditional principle of individual insurance combined with the principle of social solidarity would make it possible to achieve minimum security for every citizen and to maintain (at least approximately) the standard of living already attained in the case of those who acquire additional work- and earnings-related rights by means of contributions paid.

3. The network of social services should be developed so as to combine cure and prevention. The network should contribute both to the elimination of lasting disadvantages and to the alleviation of crisis situations. It should guarantee flexible, professional and humanitarian help adjusted to the requirements of individuals or groups with larger than average social burdens. In this network the role of local autonomies ought to be increased significantly.

4. Social policy should be based on institutions operating with legal guarantees, including new, more flexible forms. The level of education and training of those working in these institutions should be enhanced and modernized so as to develop new, and active relations, based on equality, between the institutions "making" social policy and the citizens.

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The logic and values of the economy and the society are only partly identical, and the elements do not always match without friction. While the economy is in a crisis situation, open confrontation may be avoided by financial concessions as in the case of unemployment. (In absence of these, order can only be maintained by repression, which contradicts humanism, democracy and market mechanisms alike.) In a longer view the conflicting or harmonious relationship between the two spheres will depend on the social power relations and on the impact of various ideologies.

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R. HOCH

I welcome the attempt made by a team—under the aegis of the Patriotic People's Front—to prepare a document which they believe to be suitable for providing a basis for social and economic reform involving major change. I also consider it a very significant event that—at least after a while—the political centre did not refuse the suggestion from the "periphery", but decided to discuss the document and considers the possibilities of using it. But—naturally—neither this document nor other concepts prepared by anyone can replace the party's own concept and programme of social and economic reform—they can at most help it coming about.

I was able to read and discuss four variants of "Change and reform". In my view—and according to my taste—the content of it has positively changed. Perhaps the authors would protest, but I even see a change in the concept in some aspects (while the basic concept remained the same). Since the earlier variants received wide publicity as well, I believe it is not against publishing ethics to refer to the earlier wording at some places. It is favourable, for example, that this version gives a better founded evaluation of the 1968 reform based on the 1966 resolution of the Central Committee of the HSWP, and does not forget about, but analyses the "counter-reformation" in 1972 and after. I consider this modification very important because:

—this makes it clear that the 1968 reform cannot be blamed for the current troubles and problems;

—it gives a chance to answer the question whether the current phase of the reform accepts (naturally with the consideration of the current conditions and our knowledge) the unity of plan and market;

—the authors of this document are not on a common platform with those opposing the reform.

Therefore I accept the essence and main points of the economic historical analysis of this version of the document. (Naturally, every author writes differently and puts the emphasis on different aspects in a given analysis.)

I fully agree with the main direction of the document, according to which;

—the current economic policy will lead to economic and political crisis (that, in a latent form, already exists);

—such economic policy must be prepared that leads the country and the economy out of crisis;

—radical reform is needed, and this reform must cover the society and politics as well;

—the changes will necessarily have negative economic and social consequences which must be dealt with on the level of the whole society;

—the resources necessary for the transformation must be found;

—the major change, its preparation and the guiding of execution must be undertaken by the party.

I am also deeply convinced that domestic—rather than external—factors are responsible for the current situation; therefore, widespread, consistent changes fundamentally transforming our economic management and the economy must be implemented within a short period of time. In the absence of these changes everything we have achieved in forty years will, no doubt, be wasted.

This document (also) puts me in the dilemma I have struggled with ever since 1954. Namely, should I support without reservation and criticism the tendency urging widespread changes that I disagree with in essential, conceptional aspects? Or should I be critical—breaking up the camp of those supporting the reform in this way, perhaps supporting the conservative forces against it? With good conscience, I shall (again) choose the second.

I shall not elaborate on the statements I agree with. Nor shall I mention my views and criticism (however important) concerning details.

My basic criticism is the following:

1. The document provides a definite *concept of economic policy*. Its essence is: further but stricter general restrictions, radical cuts, especially in consumption and greatly accelerated inflation. (In an earlier version, general—not only structural—unemployment was also mentioned, which is left out of this variant: however, it necessarily follows from the suggested concept.) I consider this concept unacceptable, because it is *unrealistic*.

—A constantly contracting economy—as is proven by recent experience—cannot be forced to produce an increasing amount of exports with improving efficiency.

—This tendency of economic policy disorganizes domestic cooperation.

—No radical reform can be carried out on the basis of an economic policy that gives a strategic role to the increasing use of the domestic restrictions.

—Reform is viable only if the enterprises can gain better a position in all markets (in the domestic one, too) among strict and normative conditions. More generally: the basic error in the concept of economic policy in the document is that it considers basically one, rather than three markets.

The document correctly attributes great significance to the *reception of the reform by the society*. If the society does not accept the reform, if it refuses it as foreign body, then there is no chance of succeeding with the reform. Nobody in his right mind can believe that the society will accept a reform that declares stagnation, a reduced standard of living and general unemployment almost as a strategy.

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The whole study is marked by *a pathological aversion to growth*. I would fully agree if the document suggested: growth cannot be forced among unchanged conditions, because that will lead to increased indebtedness, loss of balance and deterioration of efficiency. (This is what happaned after 1984.) Therefore, economic policy and the reform of the economy have the task to *establish the conditions* of gradual vitalization of well-founded growth (which can only be moderate at the beginning). Due to the earlier incorrect policy the temporary reduction of consumption may become unavoidable as well. An important precondition of renewed growth, and generally also of economic and social progress—including technological change and increased ability to export—is the development of infrastructure. Restriction can be abolished only gradually. The main means of restriction must become monetary policy, because this allows those fit for life to forge ahead and makes it more difficult to keep those unfit alive: after all, this is the suitable means of preparing new development.

However, the concept of the document is completely different, exactly the opposite in essence.

The main justification for being *anti-growth* is made by referring to 1984. Is this reference fair? I do not believe so! In fact, what does the year 1984 and the following events prove? The danger of insolvency was in fact—temporarily—averted, but the basis for this was the restriction of the previous years and the fact that the Soviet Union purchased agricultural products from us for hard currency. It proved to be a serious mistake not to use this break for recovering our breath to initiate fundamental changes, and the consistent tranformation of the economic structure, and to reform the economic mechanism, i.e., to establish the conditions of growth. We made a similar mistake to the one correctly pointed out in the document concerning the foreign credits in the second part of the seventies. It was evident that we could breathe more easily, not because the noose became looser, but because our neck became thinner. The general situation now is therefore: general restriction, with no selection, or more exactly, with counter-(adverse) selection (i.e., the weight of investment in energy and extractive industry has been increased in the sixth five-year plan). Many thought that we had a victory in the game that we played until 1984; however, it was a faint draw. But this performance was insufficient for further games.

I regard with increasing respect the leaders of Brasil who had the wisdom and courage to declare: the emperor has nothing on. In other words, the recipe of the International Monetary Fund—mainly based on restriction—was quite unsuited to solve their problems. They recognised that they could only escape forward. It would be very good if our leaders came to a similar conclusion.*

One of the most important questions of our future is: how can we obtain *resources*?

—We can think of *reducing consumption,* although we must know that the resources freed in this way can be converted into exports (import savings) and/or investment to a very limited extent only.

—We must seriously consider the suggestions concerning the slowing down of the *Bős-Nagymaros* hydroelectric project and the *Yamburg* gas-pipeline project.

—We can free resources if we seriously start *cutting*—if only relatively—inefficient branches and subbranches. (Unfortunately, nowadays we can read about such "cuts" in official documents that should not even be mentioned in the concept of national institutions of economic policy, but should be treated as enterprise matters.) In this way capital and labour could be released and also (mainly imported) energy and raw material which is currently wasted by these branches and subbranches.

—Logically approaching the question, a natural source of growth is the current under-utilization of capacities. Naturally, it would lead to bankruptcy if we tried to utilize them in the current structures. But, if labour and (partially) capital from the branches to be cut is transferred and in this way the capacity of activities with output acceptable and even profitable in all three markets can be further increased, then we can gradually start to grow, although it will probably be slow at the beginning.

Of the sectors to be developed I must underline the importance of *infrastructure* supplying production and population alike. Its development is necessary not for "dynamic growth", but because its backwardness is an obstacle to modern and profitable production as well as to a civilized, healthy, up-to-date way of living. One of the main reasons for the social erosion is the restriction concerning infrastructure. However, the fact—and I can prove it with calculations—that the import need of infrastructure on average is significantly lower than that of the productive sectors makes more marked development possible without significantly burdening our

* It is well known that Brasil set conditions for repaying its credits. Quite likely we cannot do so.

balance of payments. The authors of "Change and reform" express their doubts on whether the existing infrastructure is suitable for moving out of stagnation. They fail, however, to say whether they consider necessary the priority—naturally, selective—development of infrastructure. Because of this failure to take a stand, their answer seems to be negative.

There is tremendous wastage in our current economy, while artificially withheld activity is excessive generally, and especially in the socialist sector. Our economy—like Gulliver—is tied down by spiderweb-like threads. *The radical reform* has the task of cutting these in order to allow activities to develop in all sectors, and to reduce substantially the wasteful use of living and materialized (embodied) labour arising from the operation of the system. No reform should be started that does not meet these requirements, i.e., that does not release resources in this way!

—The document does not consider it impossible to utilize *external resources* for the implementation of the reform. Although we should not have illusions—we must search for the possibility to increase the direct imports of capital.

—We must be more daring in finding a way of reducing the debt burden viscerating the country.

In conclusion, yes, we can obtain the resources absolutely necessary for the changes. Paradoxically, however, we need changes for that, too.

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As I already mentioned, I fully agree with the necessity of a *radical reform of the economic mechanism*. With the policy of small steps the quality of our economic system—in the sense of economic philosophy—cannot be changed. The new institutions established more or less in isolation from each other are quickly integrated into the old system of management.

To implement successfully the critical amount of changes, the reform package must have inner consistency (concerning its individual elements), and must also be consistent with the whole society. One of the preconditions of consistency is to define *the core (the decisive link) around which all the changes are organized* correctly. We must be careful not to burden the reform with any unnecessary measure, yet to include everything important for achieving major changes in every field. Unfortunately, the document completely fails to list those steps to be made at the same time that would bring about the quality leap forward and would make the process irreversible.

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The changes must be *concentrated on the enterprise*. The most urgent task of the reform is to make the enterprises sales-oriented, that is, to allow them to survive only by the sales of their products (in the three markets), and to survive only in this way (not by bargains with and subsidies from the central management). Only in this way can the economic units become cost- and profit sensitive. All other changes must serve the aim of making the enterprises dependent on the market. This is the main reason why monetary policy must be strengthened at the expense of fiscal policy.

According to "Change and reform", the main instrument is monetary restriction. This argument is incorrect. In the hierarchy of goals and methods, monetary policy can only be one of the methods for achieving the goal of making market sales—at an acceptable cost and profit level—a question of life and death for the enterprises. If an enterprise is not cost- and profit sensitive, then the discount rate policy is hardly a suitable method to regulate the amount of money in the economy (similarly, exchange rate policy is not more efficient, either.)

We can say the same about tax policy. The fundamental change of tax and price policy is, in fact, an indispensable part of the reform. Yet only such measures can (should) be introduced that assist the changes in the conditions of enterprise operation consistently. In a surprisingly conformist manner, following the actual policy of the government word by word, the document gives the question of tax reform an excessive dimension.

—It is absolutely necessary to transfer the majority of centralized net income from production to sales, and this can be done in the traditional system of turnover taxation as well. (Perhaps some steps, at the most, should be made towards value added tax.)

—Personal taxation does not meet this requirement at all, and is not suitable for replacing income regulation either. (Although the document may give rise to such illusions.) It can, however, lead to unnecessary tensions, and therefore should be introduced in a later period of the reform process only.

—This document, like others, fails to mention that the introduction of value added tax assumes a half-year period of frozen prices (accompanied—evidently—by a wage freeze). We do not have to go into details about the possible consequences of a price- (and wage) freeze concerning the "development of the market".

—It is an illusion to believe that market prices, under the influence of demand and supply, will settle according to the price proportions desired ("guided") by the centre. This is not 1951. The price centre set by taxation is only the lower limit of prices. Following the abolition of the price freeze completely different price proportions will take shape.

—It is not specified how subsidies to enterprises should be eliminated. (At once? Gradually?)

A basic problem in our economy is *the poor performance of the large state enterprises*. The majority of the means of production is concentrated in this sphere: it is the large enterprises that employ most of the workers and white-collar staff, produce the vast majority of the social product, and earn a large proportion of the foreign exchange income by their exports. A basic question of the reform is how this sphere can be made market-oriented. If we cannot achieve a major change in the operation of the large and medium size state enterprises, we cannot talk about real reform: then all the changes become a series of second-best actions. What does "Change and reform" have to say about *enterprises*?

The study states: "A real acceleration effect can only be achieved—similarly to the experience of the past couple of years—by further increasing the number of small private enterprises." Can the past couple of years really prove anything? Having read the analysis part of "Change and reform", I must say, no. Naturally, if we do everything the same way as before, if we cannot be determined to reform the operation of the large enterprises, then the consequences will be the same, too. But then we should not talk about reform!

It is, in fact, necessary to increase the number of enterprises, to break the artificial monopoly of the (essentially) horizontally organized enterprises and trusts. (The creation of vertically organized large enterprises must be promoted. These could achieve an oligopolistic position at the most, and their vertical organization would have numerous advantages. One of these would be that significant capital and labour transfer could be achieved within the enterprise.) Despite the progress we have made, there is a task still to be solved: namely (to use Gábor *Révész*'s expression), to establish the healthy link-structure of industry and services, i.e., to assist the foundation of an appropriate number of medium and small enterprises in addition to *and around* the large enterprises operating among changed conditions.* Without this, there can be no enterprise reform implemented.

Instead of this, "Change and reform" suggests the decentralization of large enterprises as a general solution. Although I agree that in some cases this might be necessary, this is unacceptable to me as a general solution. Experience shows that forceful decentralization is subjective and bureaucratic: that it does not solve anything; on the contrary, in many cases, after deheading the dragon, all sorts of monsters are born. Enterprises of adequate size and a sufficiently dencentralized enterprise structure must emerge under the pressure of the market under the influence of the real necessity of becoming profitable. (The suitable forms can naturally be popularized by both the government and the Chamber of Commerce.)

At many places the document demands—correctly—*indifference to sectors* of the economy, i.e., the elimination of discrimination. I fully agree with this if this requirement is not limited to the private sector, but also covers the state sector. Paradoxically, the state discriminates against its own enterprises exactly by giving

* Hoch, R.: The maxi and the mini. (Reflections on the Hungarian debate on large firms). *Acta Oeconomica*, Vol. 35 Nos 3–4 (1985), pp. 251–267.

privileges to them! ("It supports them like the rope does the person who has been hanged.") The precondition of indifference to sectors is the ability of the state enterprises to set their prices and wages according to the same rules as the private enterprises: to set the state enterprises free from the burden of supply responsibility (interestingly, "Change and reform" does not mention this phenomenon), they should not be forced to export unprofitably etc., phenomena that, naturally, do not burden the private sector. I shall go even further! Private enterprises delivering goods and services to state enterprises (with the obligation of giving invoices) are also discriminated against as compared to those private enterprises who work for private persons. This discrimination will be multiplied by the introduction of personal taxation. If we demand indifference to sectors, we must tackle this problem as well.

The most important question of (large and small) enterprises is *interest in profit* (profit motive). One of the main shortcomings of the 1968 reform was that it based the system of interests as well as the system of regulators on *short-term interest in profit*. (This impact was also strengthened by the establishment of enterprise councils.) "Change and reform" correctly demands the establishment of long-term interest in profit, of interest in capital accumulation. This also raises the problem of ownership forms. There are very few clear ideas concerning ownership, and we did not become wiser by reading the document either. However, the document correctly states that establishing the appropriate forms can only be a result of a long process. In my opinion, establishing long-term interest in profit is not an indispensible part of the reform package. It is apparent from the document as well that short-term interest in profit does not work either. Therefore, as an immediate step, the establishment of interest in profit in general is necessary, and the creation of a market force (rather than the graces of high authorities) to earn profits. To achieve this only, will need wide-spread and substantial changes.

Our approach to forms of *ownership* can set the direction of steps to be made immediately. I have more than a few problems with the way the document approaches this question. In addition, the different versions of "Change and reform" differ from each other a great deal on this question. In an earlier variant the dominant form of ownership was joint-stock companies; in another holdings received the leading role. We cannot blame the authors for not having a mature standpoint in this question. (But they should not pretend that they have one.) The current version is the most appealing: it takes a stand on the need for many forms.

There are a number of conceptual (if you like, ideological) questions left open in the study.

I, too, share the opinion that state ownership on its own is not identical with social ownership; more exactly, it is not *perfectly* identical with it. The precondition of total social ownership is wide-spread social control. I acknowledge, although do not agree with, the approach that does not accept state ownership as a form of social ownership ("the capitalist is replaced by state capitalism"). It is not clear what stand the document takes concerning state ownership and self-management.

—Is the state at all included among the owners? The authors here make a "shift" between categories: they use state ownership and administrative ownership as synonyms. The reform must, in fact, push the latter into the background. But how can the state, interested in accumulating property, and controlled in a democratic way, be made to participate in the operation of the property? Does the idea of corporate ownership emerge?

—What sort of role is given to the enterprise councils, which would be trusted with the handling of property? What is meant by: "enterprises . . . currently managed by enterprise councils . . . could own securities—representing their own assets . . ." If these securities are shares, it is quite clear that it will not be the collective or its elected body which disposes the property and decides in management matters, but the assembly of shareholders and the council of directors. It does not change anything significantly if the members of the collective can (or must) also buy shares of small value. Nor does the "Mitbestimmung" (participation) within the shareholding company.

—Can individuals have unlimited capital embodied in shares?

—If we are serious about stimulating private entrepreneurs to invest their profit in the increase of their enterprises—and this is in our interest—then they must receive institutional guarantees that they can increase their share up to a certain limit, and they must be informed how, above this limit, their enterprises will become social in character; it must be organized in a way that they do not suffer either in financial terms or concerning their activities. Do the authors of the document wish to set up such a limit?

If we do not answer these questions, we shall not learn what makes the enterprise property social. (It sounds quite funny that a joint stock company becomes social by publishing its balance-sheet.)

We have accepted that the economy is going to be a multi-sectoral, mixed type in the foreseeable future. Consequently, economic regulation must not discriminate against any sector (not against the socialist sector either!): it even must assist those operating in the private seector.

Does the economy, or rather *will the economy have any sort of character?* In the 1960s and 1970s (in the golden age of Keynesianism), the economies of the capitalist countries were called mixed. (They still are.) However, there was never any doubt about the domineering sector in the economy being the capitalist sector ("private enterprise") and that the public sector is to serve the better operation of the capitalist sector. The limits and magnitude of the state sector were and are set by this requirement. I must ask again: do we want to develop our mixed economy into a characterless economy?

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The radical reform of economic planning is an indispensable aspect of the reform package. This is necessary not because the role of monetary policy increases (that is mere detail!) but because we want to change the conditions of operation of the enterprises: because we wish to give a different role, than in the past, to the mechanism of the interrelations between demand, supply, price and profitability.

This is why it is unacceptable that "in the new setup, economic planning becomes mainly the preparation and continuous maintenance of a macro-level financial programme". This also must be part of the national economic plan, but it is not the national economic plan itself. In a modern state even the essence of economic policy is more than just this.

The basic question of the reform remains the same: do we maintain or discard the concept of controversial unity of *plan and market*? This question arises in a different way than in 1966 (then we did not really answer it); the notion and methods of planning must change significantly as well. Planning must be given a strategic character first of all, and the so-called operative planning must be eliminated (or at least strictly limited.) (Operative planning must be replaced by the financial programme.) In more general terms: we must determine what is and what is not the task of the central management. We must ensure that everyone minds his own business (because they usually do not); and we must institutionally prevent them from dealing with matters that are not their business. An extremely important question in this matter is: what should the division of labour between party and government look like? I fully agree with the demand that parallel activities and organizations should be elmiminated.

The document correctly states: "The reform needs a stronger and more united government than the current one". The state of matters when the government is a forum for the heads of sectoral and functional ministries to match their interests, must be abolished. The policentric management of the economy must be pushed into the background. However, if we accept all this, then the correct slogan of the reform is not "let's decentralize". Then the correct goal (largely simplified) is: *let's decentralize in the enterprise spheres, and concentrate on the sphere of economic policy and planning.*

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"Change and reform" is a reform concept with strong features. The main question is not what are the aspects that we agree with and which are the ones that we do not. The real problem is that there is still no official reform programme for or against this one, that could be included in a resolution and used as an operational programme. Such a reform programme can only take shape if the party organizes the preparation work—similar to the preparation preceding the 1966 resolution. In this work all the valuable elements of "Change and reform" must be used. The reform programme must be prepared and approved with the intention of introducing it immediately. If we fail to do so, the ominous forecast of "Change and reform" will come true.

E. KEMENES

"Change and reform"* is of mixed form and character: it includes economic arguments on the one hand and is like a political pamphlet on the other. Since the study offers ideas and suggestions that are based on economics and born with politics in mind, it is useful to provide both an economic and a political analysis of it.

I consider the fact that this study has been prepared as positive: it presents a general and complex approach to the economy and economic management that also considers social relations. It provides a chance for experts and the managers of economic policy to clarify their views and take a stand in relation to this study. It is by far more favourable than the partial raising of and discussion of certain aspects of this concept over the past few years which did not have a sufficient overview and definition. In the past, this sort of practice of discussion often resulted in controversial and confused situations and disturbances in the professional public atmosphere as well as in the economy, and led to uncertainties in economic policy. It is a different matter, though, whether we identify ourselves with the report's approach towards the economy and economic policy,or criticize it, I shall present my opinion on this issue later on.

Concerning its political standpoint, the study is of a critical character. It formulates statements of sharper criticism on a number of questions compared to what the usual style of criticism and self-criticism is in public fora and in the internal fora of the party. Some of these, whether correct or not, are irritating and hurt interests. Yet we must see that most of them are no more than putting the thoughts of the general public into words: "the current economic policy is not suitable to implement the necessary change", "the political set-up is to maintain the status-quo", "the economic policy is responsible for the current severe situation in the economy", "there is a crisis of confidence between the leadership and enterprises and small private enterprises" etc. In this context I believe that the criticism of economic policy and politics in the study does not cover power-political aspirations, its aim is not to discredit the current political leadership and practice, but serves as ideological background for the alternative suggestions of the authors, even though sometimes out of proportion and going a bit too far.

* I make my remarks on the basis of an earlier longer version of the study.

As regards its *economic message,* the study points out that the economy was out of breath in 1985–1986: it takes notice of the worsening solvency crisis and the structural and institutional crisis behind it. As an explanatory variable, it points at the mistaken orientation of economic policy and its mistakes as well as at the decision-making system and system of institutions creating those mistakes. The authors believe that the solution is a strict monetaristic economic policy both in the long run and in the current crisis situation. It is difficult to evaluate this economic message because the description uses declarations rather than arguments. The authors form their condemning criticism of economic policy without investigating the circumstances (scope of movement, factors, etc.), on the basis of the current situation. However, the evaluation of the state of matters by the authors is a declaration only, and they present their suggestions as evident and as the only solutions without proving them. There is no indication of troubles and difficulties accompanying the suggested solution either. Even if we accepted the message of the study as correct and realistic, the way of presenting it is still not acceptable, and this fact weakens the convincing evidence of the given study. On the other hand, this declarative way of arguing hides the danger of undiscerning, uncontrolled acceptance by non-professional circles.

According to its title, *Chapter I* of the study wishes to *evaluate the economic and social situation.* In fact, it describes, very briefly, a few economic phenomena reflecting a crisis situation. These are correct, factual statements, the number of which could be increased on the basis of analyses in the economic literature (for example, market problems, problems with domestic reproduction, stocks, etc). The arguments concerning the CMEA were not written from the point of view of the Hungarian structural crisis. Concerning social problems, the authors only point out the crisis of confidence defined as an operational problem of the political system, while many structural problems revealed by scientific research and political practice (for example, problems of demography, social structure, mobility, etc.) are not even mentioned.

In essence we can accept as a starting point the message contained in *Chapter I* (weak ability to adjust, solvency, growth and structural crisis), not because the arguments are convincing, but on the basis of the domestic economic and social state of matters that we are familiar with from other sources. However, the picture presented in the study is superficial, unstructured and does not indicate processes and determinations. In this way it basically neglects the problems to be solved by the suggestions elaborated on later, and does not clarify the scope and determining factors of the desirable economic policy. In other words: the suggestions are connected to this briefly and superficially described situation only through transmissions and in principle; they do not stem from a detailed analysis of the situation.

The study detects *the roots of the crisis* in the errors made in the economic policy and in the malfunctioning of the institutional system. The restrictive policy of the 1979–1984 consolidation period created an apparent balance behind which the structural problems remained. This, however, was not recognized by the economic policy. In the name of revitalization, an unrealistically large number of priorities, even contradicting each other (more dynamic growth, anti-inflationary policy, improving the standard of living, modernizing the production structure, full employment, restoring the balance of payments) were accepted for 1985–1986. The problems originating in the inadequate actions of economic policy were accentuated by the constant contradictions in the system of economic institutions: lack of market relations, malfunctioning of the indirect central management, ambiguity of the reform process.

I do not believe that the roots of the 1985–1986 crisis can be blamed exclusively on the direction of the economic policy in these two years. The structural crisis is the consequence of a longer process. We can find the roots of the problems emerging in 1985–1986 first of all in the development and economic policy of the earlier period. The source of the problems must be found in the delay of structural adjustment to the world economy, in the negligence of economic policy in the second half of the 1970s, that was admitted above, and in the general and non-selective, structure-maintaining restriction—less analysed so far—of the period between 1979 and 1984. The other problem with the attitude of the study is that the above mentioned criticism of economic policy ignores the external effects and determinations that, however, strongly influenced the scope, preferences and methods of the economic policy in those years. Thus, summing up, the study fails to describe the real scope of and constraints on the economic policy in 1985–1986. Yet arguing about the errors in the direction of the economic policy on a realistic, well-founded basis is only possible if all this is taken into consideration.

I find the description of the mechanism, as well as the structural problems of the institutional system and the characteristics of its operation correct. This description, however, fails to include the important question of the above mentioned interrelations, namely the problem of the economy's mechanism for adjustment to external markets, i.e., the way of linking domestic and external markets. This factor, in addition to the ones mentioned in the study, plays an important role in the actual efficiency of structural adjustment.

The crisis-managing *suggestion of the study offering major changes is: introducing radical market reform*, as outlined in *Chapter II*, and the authors wish to base that on social and political reforms *(Chapter III)*.

The starting point of the reform suggestion made in *Chapter II* is the current economic situation and the task of consolidation necessarily following from that. The authors of the study attempt to find an optimal solution by analysing the possibilities and alternatives of economic policy within the narrow scope of action. This solution would lead to a halt in the increase of debt within two or three years and would, at the same time, initiate and implement radical structural transformation in order to establish an efficient economic structure which would then adjust to the world market. The programme-creating work in party and government circles has the same intention; therefore we can agree with this suggestion of the study.

The authors consider it necessary—in the framework of the programme they believe to be optimal—*to reorganize the priorities* of economic policy. In this aspect, structural modernization is most important. This would mean the more radical (than at present) elimination of the sources of losses on the one hand, and the utilization of all domestic and external resources for structural modernization on the other. This requires the strict limitation of domestic consumption, with growth only possible on the basis of profitability in external markets and improvement of the debt position. It would also require relinquishing the goal of maintaining the standard of living and full employment; furthermore, some retreat must take place in certain international commitments taken on earlier (defence, joint investments). The direction of the changes in priorities is set by the characteristics of the situation, it is a product of realistic thinking, and the economic policy of the government is busy with arranging these priorities as well. It would give *reality* to the suggestions if the authors investigated the possible scope for changes considering the domestic structural determinants, external relations and the constraints on domestic resources as well as social constraints. However, this study *fails to provide* this analysis. It does not even indicate the possible magnitude of the changes. Among such conditions, how can we accept the promise of halting the increase in debt, the idea of revising our external commitments or reducing the standard of living as realistic possibilities? *Concerning the foundation of the suggestions, I consider the lack of clarification of the time horizon and possible magnitude of changes as a significant weakness in the study.* This makes the message of the study concerning the meaning and length of the consolidation period uncertain, and weakens its credibility.

The study elaborates on the suggestions for the *further development of the mechanism*. It is difficult to analyse the economic message of the suggested reform package though, because a significant number of the ideas described in the study are already being carried out in the course of modernizing the government management based on the Central Committee resolution of 1984. In comparison, I can recognize new elements in:

—the demand for a rigorous restrictive monetary policy (this presupposes a strong government and more definite monetary direction);

—a radical reduction of budget expenses, cuts in defence expenses, limitiation of the central bureaucracy, a halt to the costly large investment projects;

—a definite and public solution to the question of crisis industries;

—the transformation of enterprise self-management into joint ownership (by shares, etc.);

—a central programme for boosting competition, and a government programme for organizational decentralization;

—the creation of a central competition policy against cartells and monopolies.

The main line of the suggestions indicates a strict monetarist approach. In this aspect my main problem is that because the Hungarian economy is scarcely monetarized—and we cannot expect *qualitative* changes in the short-term even if this alternative were chosen—the processes cannot be regulated with monetary policy *only;* the economy is integrated not only by money. In the system taking shape from these suggestions, the real role of the *state,* other then making monetary and fiscal policy, in the consolidation period is not clearly indicated. Price policy and *price system* are not mentioned. Naturally, with market competition taking over, the significance of price policy will decrease. However, until then it will remain significant (in the period of consolidation as well). The authors also fail to make a suggestion about the future of *CMEA relations,* which are extremely important for our economy. On the basis of international experience it is evident to me that monetary policy on its own is insufficient. The mixed capitalist economies cannot be regulated solely by monetary policy either. It is true that the large-scale economic restructuring in the industrially developed capitalist countries in the late seventies was accompanied by restrictive monetary policy, but the further—although different than earlier, but still very important—role taken on by the state was very clearly defined in all of these countries (eliminating the sources of losses, introducing new technology, building up the new elements of infrastructure, taking on social burdens etc.).

The suggestions in the study concerning the development of the economic mechanism can be considered as an experiment to adapt a monetarist model believed to be efficient, rather than initiatives to develop made on the basis of analysis of the actual problems of the consolidation period. Even so, most of these suggestions can be considered—accepting the arguments in the study and on the basis of other investigations—as rational. Therefore, in the given situation, I support in principle (since the real meaning of the suggestions cannot be evaluated) the suggestions concerning the strengthening of monetary regulation, currency devaluation, the renewal of the fiscal system and initiatives to develop the market. However, these on their own are *not sufficient* for crisis management. I believe that in our mixed economy the questions of the role of the state and the development of the central administration should be analysed with the same intensity. The system in which the programme of getting out of the crisis would be implemented, I believe, would be still mixed (although mixed in a different way than earlier). Whilst accepting deregulation in some aspects, concerning other functions (questions of structural policy, technical, technological development, development of infrastructure, social security system) I consider the development and maintenance of a more active role by the state necessary in order to carry out the consolidation successfully. On the other hand, concerning the leading sectors, the external pressure (see devaluation) needs to be increased in an economy with a weak and diminishing ability to compete. However, letting the conditions of international competition bite without any mitigation would result in an immediate failure of the economy to perform. Providing sensible protection for the economy and transmission channels for the new conditions is a task of the state in the period of consolidation that cannot be shifted onto anybody else. Thus, all in all, I consider the suggestions of "Change and reform" on the development of the economic mechanism useful, but I believe that the rethinking of some further aspects, as well as the sensible composition of the mixed system are still tasks to complete. In order to deal with the suggestions, we should have a picture of their expected *effects* on reorganizing the economy and society. The study fails to provide information on these, and therefore we remain quite uncertain as to their feasibility.

In evaluating and judging the suggestions for economic policy I have problems with the fact that the authors prepared their suggestions with the operational mechanism in mind; the study does not tackle the *structural questions and processes* of the revitalization. Yet the ability of the suggested system to function is clearly influenced by structural problems and transformations, such as the position of and changes in food production, the crisis industries (the authors suggest separate treatment for these, if I understand them correctly), the questions of technological modernization, the development of infrastructure, etc. Naturally, the inertia of these fields and the possibilities to change should be "estimated" as well. Without such an investigation the reality of the new suggestions' radicalism *vis-à-vis* the economic mechanism, and the real chance of economic revitalization cannot be judged.

In relation to the evaluation of and suggestions for economic policy, the study also tackles a wide range of *social policy questions*. According to the study, the reform programme cannot be limited to the economy, since the behaviour and actions of people integrated in the economic relations are influenced by other aspects of social relations as well. The study pays very close attention to the role of political relations and system, taken in the closer sense, determining the economy.

Of the political problems determining the current situation the authors emphasize the impact of policy on the maintenance of the status quo and the avoidance of conflicts which have led to increasing economic contradictions. They also look at policy in relation to the problems of government responsibility, the braking effect of the confidence crisis between central management and the economic units, and the consequences of the limited openness of the society. The questions of social reform attached to the economic reform are also emphasized among the suggestions. These are: economic constitutionality, greater control over the excecutive powers by the National Assembly and by the press, the redefinition of government responsibility, the development of organizations publicizing and representing interests, initiation of a reform movement, and the role of the party, as supporter and vehicle of the reform as well as the definition of this role.

These suggestions point towards a more democratic political structure and mechanism. This is in harmony with the intentions of Hungarian political thought, therefore it will presumably assist the process of economic revitalization. However, due to the lack of appropriate analyses, it is questionable why exactly these suggestions are the efficient ones, or how efficient they are in assisting economic revitalization. Compared to the likely economic changes in the period of consolidation, the suggestions for political reform are more radical, and their different aspects have significance beyond the arguments presented about the economy. This is quite apparent from the suggested annual time-schedule of changes.

It is also a problem for me that in this study, which strongly accentuates social interrelations and where the approach concentrates on problems of the system of political institutions, other social questions, like work, moral, cultural and social spheres hindering or assisting economic revitalization are missing. In my opinion a major shortcoming of the study is that while it indicates the neccessity of some reversals in the standard of living and in employment, while the demand for performance will increase, it does not at all tackle the possibility and methods of managing this problem politically. I also consider it important that the functions, meaning, possibilities and risks of the suggested economic and political reform processes should be made clear for the individuals—without this the reception of the reform ideas by the society can hardly be favourable. Whilst the study underlines the necessity of developing a more open society, it does not tackle this evident and very significant question.

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In summary, when evaluating the whole study, I find the intention of the authors to improve, as well as their search for a way out, and the open, critical style of the study appealing. However, I find it problematic that many times the radical criticism is not based on convincing analysis. It seems to me that the suggestions believed to bring about major changes were born not in the analysis of the actual situation, but they are rather an attempt to adapt a theoretically prepared economic and political model, for the adaptation of which the justification is the crisis situation and the necessity to get out of it. While the study criticizes the current practice sharply and refuses to consider any different approaches, it does not control the *feasibility* of its own ideas. It supposes or even promises advantages and results (for example improved competitiveness in the world market, etc.) without indicating the unavoidable negative consequences, unfavourable effects and the accompanying economic and political risks. However, all these weak points of the study have not made me reject it. On the contrary: I consider it necessary to make up for the shortcomings of the study, to base its suggestions on actual analysis and to control their reality and feasibility in this way. If these further developments are completed, then the ideas and suggestions of the study will be a suitable basis for real economic and political consideration. Apart from this, I think that the study even in its present form contains many elements that can be fitted into the actual or under-preparation action-programmes of economic policy; therefore it is worthwile considering their practical implementation in the short-run as well.

I. TARAFÁS

I welcome the preparation and discussion of this study because it can contribute to a wider awareness of our economic situation, to the common search for a possible way out and to a better social reception of the absolutely necessary changes and unavoidable sacrifices. The study is correct in approaching the economic reform as part of an overall reform programme, including the political and social spheres as well. Below I shall express my opinion only about the chapters of the study dealing with the economy.

1. I basically agree with the evaluation of the reform process started in 1968, including that "finally an indirect planning system took shape, in which... breaking down the plan was substituted for... breaking down the regulators" (p. 191). However, it is difficult to understand the emergence of the current situation and the future possibilities because the analysis of the economic policy of the eighties is very superficial, therefore the conclusions drawn are not always correct.

Concerning economic policy, the eighties are divided into two very different periods. Between 1979 and 1984 the domineering goal of the economic policy, both in declarations and in reality, was to restore the foreign economic balance and to reduce debt to some extent; economic growth, domestic consumption, the stability of the price level, etc., were all subordinate to this goal. For the economic policy of this period it is correct that (one of) its main pillar(s) was the expectation that "...the strict limitation of domestic demand... would encourage... enterprises... to increase their convertible currency exports" (p. 193). The main instrument of cutting domestic demand—in addition to raising consumer prices and the prices of energy, including the 1980 price reform—was to increase enterprise taxes, especially in 1982–1983, at the time of the acute liquidity and solvency crisis. This gradually degenerated into administrative restriction. The continuous introduction of new taxes and tax-type charges were applied more and more to the efficient enterprises only; the burden on the inefficient ones increased to a much smaller extent. Thus the generally restrictive economic policy could not initiate the structural transformation of the economy, and its effect in forcing enterprises to improve efficiency was diminishing, too.

However, in retrospect I believe that the economic policy during the period of the liquidity crisis was basically correct, because maintaining our solvency required—

among others things—the immediate and significant improvement of the balance of payments (balance of trade). An economic policy forcing through both a significant improvement in the balance of payments and structural transformation would have required drastic cuts in domestic consumption that would have been very difficult (if at all possible) to implement in the framework of the norms usual in the past 30 years. However, it is true that economic policy did not take aim at gradual structural changes even to the realistic extent, the effect of which would have been tolerable. Thus the short-term results disguised the future problems flowing from the gradual devaluation of the economic structure.

The economic policy and national economic management in 1985–1986 were completely different. Having survived the liquidity crisis, an atmosphere of relief prevailed in which economic "dynamization" was called for: in many areas demands quickly multiplied for the maintenance and later increase of real wages, and especially for the increase of enterprise income. At the same time, a further gradual decrease of the convertible currency debt remained an important goal. This double target implied such strong increases in efficiency and income, the strenuous character of which was felt from the very beginning. In addition, conditions independent of the economic policy deteriorated to a large extent (the cold winter of 1985, two consecutive years of drought, sharp fall in the terms of trade in 1986 etc.), which was hardly forseeable. All this—accompanied by the "taut" goals—made the parallel achievement or even approaching the policy goals concerning growth, domestic consumption and external balance very difficult, practically almost impossible. In this situation economic policy—although not the declared policy, but the everyday, practical, decision-making one—lost the self-confidence that otherwise would have been justified, at least in retrospect, by the fact that it turned the \$1100 million convertible currency trade deficit of 1979 into a \$700 million surplus in 1984; and that its success in overcoming the 1982–1983 liquidity crisis without serious social or economic disruption was internationally acknowledged.

Instead of forcing enterprises to improve efficiency and transform their production structure, national economic management got locked in everyday bargaining with different groups of enterprises and sectors, and with the organizations representing their interests at all levels of economic management about the conditions on the basis of which the latter were willing to promise steps toward "taut" goals of strenuous growth and external balance. This everyday bargaining by which favourable conditions could be gained favoured first of all the structurally retrograde activities and irresponsible enterprises which, in the case of a different economic policy, would have had to face the toughest constraint to adjust.

However, the almost permanent opportunity to obtain subsidies, advantages, exemptions, exceptions and preferences turned the attention and energy of even the efficient—or potentially efficient—enterprises to the process of bargaining with the authorities rather than to market adjustment and improving efficiency. Therefore, in this period, "the strict limitation of domestic demand" was not the case in the least; on the contrary, the subsidies and exemptions obtained in permanent bargaining increased the incomes of enterprises and later that of households—without any improvement in economic performance—while the budget deficit increased spectacularly. The balance of foreign trade turned into a $400 million deficit in 1986 from the $700 million surplus in 1984.

All this took place despite the fact that from the middle of 1984 a comprehensive programme for the further development of the economic management system was ready and adopted; this certainly included no lesser suggestions than are included in "Change and reform". What is more, from the beginning of 1985 we have gradually put in place most of the "reform institutions" envisaged in the 1984 programme. With no intention to provide a full list: in 1985–1986 most enterprises in the competitive sector were transformed into the new management forms; instead of the earlier ex-post tax-like charges, falling first of all on efficient enterprises, we have introduced a tax system much more favourable to natural differentiation; we have started to introduce the so-called earnings-level regulation that was much more rational than the earlier earnings regulations; in the framework of the "price club" we gradually—at that time, in fact—liberalized price regulation; we have prepared the new system of bankruptcy proceedings; the decentralized banking system is already in operation, etc. Naturally, the gradual implementation of the reform programme approved in 1984 involved the disadvantage that the reform institutions that presupposed each other's existence were established at different points of time, thus the actual system, at any moment, operated less efficiently than could be expected in principle. However, the main problem, in my view was that the kind of economic policy described above made the operation of the new reform institutions formal in many aspects and overwhelmed the process of reform gaining strength from 1984 onwards. In the atmosphere of such an economic policy some of the reform institutions operated in a distorted way only. For example, the new forms of enterprise management could not cut the umbilical cord attaching them to the central economic management, since bargaining with the authorities had become (and remained) an excessively rich source of survival. Some other reform institutions—earnings regulation, for example—gradually slipped back to the original state, whereas some—for example, the bankruptcy regulations—were not used in practice.

Can we really go as far in simplifying the picture as saying that the real root of our economic problems... "is to be found in the economic mechanism" (p. 195)? What sort of other economic reform institutions—beside the ones established in the past few years—would have been (would be) necessary and sufficient in order to "establish the conditions for the reasonable operation of market mechanisms" (ibid.), that, through their sheer existence, would guarantee the correctness of everyday economic policy as well? Perhaps a "substantial currency devaluation" (p. 199) or the unspecified "monetary restriction" (pp. 201), or the tax reform, or perhaps national economic planning transformed into the "preparation of a macro-level financial programme" (p. 204)? Let us look at the solutions suggested by the authors.

2. For about 20–25 years the question of exchange-rate policy has been the subject of heated debate among Hungarian economists. One group of participants from time to time suggests a substantial devaluation, partly on the basis of the theory that devaluation stimulates exports and reduces imports, partly because it believes that "individual stimulants to exports" can be eliminated or significantly reduced (p. 199).

The other group of participants argues that the export stimulating and import reducing effects of devaluation hardly assert themselves in our economy, and the existence and magnitude of "individual export stimulants" are related to the rigid structure rather than to the exchange rate. At the time of preparing actual changes in the exchange rate we always investigate the possible export stimulating effects to be expected for the efficient exporters as a result of devaluation, the expected reduction of inefficient exports and, related to that, the changes in the budget. Furthermore, we investigate the expected import reducing effect. In fact, devaluations have not, so far, contributed significantly to the improvement of the export structure and we have not noticed any import reducing effect either. We usually also discuss how devaluation will affect domestic producer and consumer prices and, in relation to that, the balance of the budget as well as the incomes of the enterprise sphere, and also how all this can be fitted into the system of goals and instruments of economic policy. "Change and reform" now suggests—as a key element in the consolidation and reform programme—a substantial devaluation, mentioning only a few of the many consequences, and even those it treats only in an unorganized manner and in so general terms that would be unacceptable even in a basic textbook. (Thus, for example, according to p. 199, "the best stimulation" for the efficient transformation of the economic structure is a "substantial currency devaluation"; according to p. 204, the inflationary effect "is greatly moderated by consistently applied monetary restriction", etc.) The authors do not even bother about harmonizing their suggestions for exchange rate policy with their own ideas in other fields. Thus, for example, right after announcing the need for a "substantial currency devaluation", they state that "the most efficient way of" cutting personal consumption is "large-scale cuts in the consumer price subsidies that cannot be socially justified and sometimes are definitely unjust" (p. 199). I agree. Yet, being familiar with the approximate magnitudes, I am sure that if the inflationary effect of a "substantial currency devaluation" is added to the "large-scale cuts" in consumer price subsidies—albeit "greatly moderated by a consistently applied monetary restriction"—this will give a strong inflationary push to the economy that only in text-books evaporates as a once-for-all increase in the price-level. I only know of examples in economic history, when price-level increases, believed to be once-for-all, became constant and accelerating, until slowing down inflation became the number one priority of economic policy to which every other goal got subordinated. I do not mean to accuse the authors of "Change and reform" with the intention of proposing galloping inflation; I only think their suggestion about "substantial currency devaluation" is not thought over sufficiently, therefore it cannot be taken seriously. Also missing from the paper is a more demanding economic analysis of exchange rate policy which would investigate whether the cause of the rigid export structure lies in the exchange rate level or rather in the rigidity of the whole (not only export) structure. This rigidity is a result of the general economic policy environment correctly analysed in the first part of the paper (and also described in the previous point of this contribution). Yet if this is the case, is it really the exchange rate that has to change "substantially" in order to bring about changes in the structure? A professional economist could be similarly flabbergasted by the following grave statement: "Obviously: without an overall tax reform no rational structural policy can be implemented... nor can a capital market and system of interest based on the inherent need to be profitable be developed" (p. 203), (the text goes on to list a couple more of the important, but impossible-without-tax-reform tasks) despite the fact that "tax reform on its own is financial technique only (same page, same paragraph). I do not deny, and even agree with, the importance of tax reform, but if we take the sentence quoted about the importance of the tax reform seriously, there is small wonder that a frantic revitalization of the economic structure has not taken place so far. In this case the first 23 pages of "Change and reform" is but one big misunderstanding, because it should have stated that, unfortunately, we have not introduced a tax reform in the past, therefore we were doomed to helplessness and failure in all aspects of the economic policy. The real explanation is that those structural and related income-allocation changes that economic policy could not implement so far, now must be implemented in the framework of a tax reform, "supported" by a tax reform. The decisive question remains whether there will be enough resolution and consistency to realize this intention.

3. The authors suggest the introduction of auctioning of hard currency quotas, and with this, a dual exchange rate. I consider this a very harmful idea. If, for different reasons, we keep inefficient or marginally efficient activities and enterprises alive, then, in the suggested system, we either supply them with the necessary imports at the official—cheap—exchange rate, or they will be forced to buy convertible currency and, in this way, imports, at the free market, i.e. expensive, exchange rate. But in this way subsidies and exemptions to them will have to be increased; therefore the free market exchange rate will increase more and more, and, parallelly, either the budget deficit will increase, or more will have to be taken away from the efficient enterprises. If we do not do this, but implement strict budget and monetary policy as suggested in the paper—

an idea I greatly support—and let activities and enterprises not fit to survive in the market die, then—by carefully choosing the amount of purchasing power (money) to be issued—the gradual achievement of liberal import regulation is just as possible as by the system of hard currency auctions suggested by the authors. Whether economic policy chooses this way or the other, the suggested system of hard currency auction carries the risk of destroying the financial system, and does not promise any advantages to counterbalance this risk.

4. What plays a much more important role in the paper than "substantial currency devaluation" and "hard currency auctions", is monetary policy, most of the time by indicating its character (restrictive) as well. Having read and re-read the relevant parts of the paper several times, it seems to me that the authors mean by "monetary restriction" not more nor less—definitely nothing more specific—than the following: aggregate demand must be regulated by the correct choice of the amount of money issued. This amount of money should be emitted mainly through credits granted by the competing commercial banks based on business considerations (and through sales of foreign exchange by exporters for forints), and not through financing the budget deficit with bank loans. If this takes place, then there will be no need for administrative limitations and a budget policy that "is a serious burden to the economy" (p. 201). Under such circumstances, "the process of efficiently restructuring the economy on which long-term economic growth could be based" (p. 201) will begin. I fully agree with the basic idea and welcome it, especially because there still are many experts demanding the "liberalization" of money creation and excessive budget expenditure resulting in extra resources and who want to "dynamize" the economy from the demand side. I must point out, however, that this idea of "Change and reform" is far from being dramatically new; indeed, for many years now, there have been a countless number of published and non-published papers calling for equal conditions for everybody, for cutting the budget deficit, for increasing the role of bank credit in financing the economy, for doing away with subsidies and for reducing the taxes burdening mainly the efficient enterprises, etc.

If I understand correctly, according to "Change and reform", monetary policy would take over not only the full role of national economic management, but also the role of planning, since the latter "will be transformed mainly into the preparation and constant maintenance of a macro-level financial programme" (p. 204). From this point, however, the idea is hopelessly murky to me. What can "determining the conditions for external and domestic financial balance (foreign trade balance, interest payments, current account balance, etc.)" mean? (ibid.) Monetary analysis, the basis of monetary policy—as could have been read in any textbook on this topic—does not take, as a starting point "the need for finance originating from the changes in income positions" (ibid.) but the need of the economy for money or, in technical terms, the demand for money. The demand for money is no other thing than the need, intent, attempt of the economic units ("large groups of income holders") to hoard money; this, with some simplification, is motivated by two factors. The lack of synchronization between receipts and payments and the possibility of unexpected expenses lead to the hoarding of money for transaction and liquidity purposes. If the technique and customs of payments and the services of the banking system do not change considerably—this is usually the case in the short-run—then the transaction and liquidity need for money, i.e., demand for money, increases approximately proportionately to nominal income. Additional demand for money is induced by savings in non-physical goods; in a rudimentary financial system, from which ours is not very far for the time being, the only possible way of saving in non-physical goods is hoarding money, the hoarding of cash and relatively short-term bank deposits. Since savings, with simplification, can also be considered a function of nominal income, it can be said that the part of demand for money, which originates in the motivation to save, also increases in proportion with nominal income.

In a more sophisticated financial system, which we have started to develop for some years now, there are several financial, in addition to monetary forms of saving. The financial forms of saving compete with the monetary forms, therefore when estimating the demand for money in such a financial system, factors other than nominal income must also be considered that reflect the effect of financial forms of saving that compete with money or the demand for money.

Coming back to our—still relatively simple—financial system, the estimate of demand for money can be based on nominal income. Planning, estimating the nominal income and the changes in nominal income consist of two parts; on the one hand, estimating the likely magnitude of real (volume) growth as a result of expected natural, foreign economic etc. circumstances, and the likely extent of improvement in efficiency due, *inter alia,* to economic policy measures introduced or intended to be introduced; on the other hand, a reasonable inflation-rate target and, on this basis, the likely magnitude of the increase in nominal income reflecting the anticipated real growth and inflation. In the next step, the supply of money consistent with the planned/estimated changes in real income and inflation—consistent, as it could be said, with the maintenance of domestic financial balance—can be determined on the basis of the past relationship (functional relation) between nominal income (nominal GDP) and the quantity of money (cash and bank deposits of all economic units). After this, the planned or desired external balance position must be considered. If, for example, the aim is surplus in the current account, then we must consider that the surplus of the current account creates money in the domestic economy (naturally, this also is more complicated in more sophisticated financial systems where the international movement of capital is generally more-or-less liberalized). Therefore, the planned level of money issued through other channels must be reduced by the surplus of the current account (if we aim at increasing the external debt, then it must be increased by that much). This is how we get the estimate of the amount of bank credit consistent with the planned economic development, and the instruments of monetary policy designed to bring it about. The amount of credit granted can be more and can be less than the "need for finance originating from the changes in income positions", i.e., the demand for credits.

The authors of "Change and reform" correctly recognize that the monetary targets set must be adjusted consistently, since—for a number of reasons—actual nominal income growth can be different from the plan. The relationship between nominal income and the demand for money can also change, and can only be estimated with considerable uncertainty to start with. In addition, the instruments of monetary policy need continuous adjustments also because the relation between those and the actual amount of credits granted (money issued) by the banks is not necessarily stable and precise. (While on the instruments of monetary policy, I should just mention in parenthesis that even if enterprises—credit receivers—are very cost-sensitive, monetary policy using only indirect instruments—refinancing rates and money market operations—can only be seen in countries where the money and capital markets are deep and well structured. But other quantitative regulations, for example reserve requirements, are applied even in such countries. Therefore the passing reference to the instruments of monetary regulations on page 201 in "Change and reform" is rather naïve.)

As far as I am concerned, I do not know of any country where all economic policy does is defining the demand for money in the economy and designing the different instruments of monetary regulation to bring about the desired change in money supply. In most countries I know to some extent there are also social-agricultural-, regional-, foreign economic (trade)-policies, etc. not to mention the numerous other sectoral and other interest groups that are strong enough to manifest themselves as political factors, thus factors of economic policy. In this country it is on national economic planning that falls the task of ensuring a more-or-less consistent set of compromises arrived at among them and of regulators or policy instruments designed to bring them about. In other countries it is the ministry of economy, or the ministry of finance, responsible for the budget (together with the Central Bank that, in most countries I know to some extent, is formally or informally subordinate to the ministry of finance). The particular interests and claims that are to be harmonized are often formulated in physical terms. This is not a Hungarian speciality either, although it is true that the share of claims formulated in physical terms is too high in this country. Therefore we have been striving for a long time to increase the weight of financial planning significantly.

5. I find the chapter on "Preconditions for the new period of reform" erudite, serious and responsible (naturally, with the exception of "substantial currency devaluation" that does not fit here anyway). I agree that the alternatives for economic

policy listed under a)-d) exist, but the only sensible and responsible choice is d). This is the conclusion of some other analyses recently completed as well.

*

In summary, in spite of the weak points criticized from a professional point of view, the fact that the thorough way of thinking about the problems and possibilities of our development has left the usual boundaries and ways is most welcome. Also welcome are the specialists, who, realizing the severeness of the situation, initiated this sort of public debate to find the way out, and took the "risk" of expressing their opinion openly. The paper and the discussion on and around it can significantly contribute to the understanding and acceptance of an economic policy which can result in further development in the long-run—requiring, however, significant sacrifices in the short-run—not only in narrow professional circles but also in the wider public.

STAND TAKEN BY THE ECONOMIC PANEL OF THE CENTRAL COMMITTEE OF THE HSWP

The Economic Panel has discussed the study "Change and reform", and summarizes its opinion on the arguments of the study below.*

The authors of the study intended to assist in finding solutions for the current problems; in many aspects successfully. Their intention to improve the situation deserves credit, even though certain aspects of the evaluation in the study and some of the suggestions are questionable.

The authors' ideas correctly reflect that our social and economic progress needs strong and harmonized steps in economic policy together with the consistent implementation and further development of the reform announced in 1966, and reform measures promoting the development of social creativity. Therefore the study deserves close consideration, and everything that is progressive in it from a social and economic point of view, should be utilized. It is important for the actual formation of economic policy that we prepare alternative suggestions which the party and government leadership could consider when preparing the programme or concept of solving our economic and social problems.

* President of the Economic Panel: Ferenc *Havasi*, Members: Ádám *Angyal*, Iván T. *Berend*, József *Bognár*, Márton *Buza*, Béla *Csendes*, Béla *Csikós-Nagy*, György *Enyedi*, István *Erdei*, Zsuzsa *Ferge*, István *Hagelmayer*, István *Hetényi*, Róbert *Hoch*, István *Huszár*, Kálmán *Kulcsár*, Ernő *Kemenes*, Miklós *Németh*, Rezső *Nyers*, Vera *Nyitrai*, Tamás *Sárközy*, Imre *Tarafás*, Márton *Tardos*.

The following members of the Panel participated in phrasing the viewpoint: Iván T. *Berend*, József *Bognár*, Márton *Buza*, Béla *Csikós-Nagy*, István *Erdei*, István *Hetényi*, István *Huszár*, Rezső *Nyers*.

On the evaluation of the current situation

The Economic Panel basically agrees with the evaluation of the current economic situation of the country, and considers the diagnosis of the study correct. Although this diagnosis is similar to the conclusions of earlier analyses of leading political and governmental bodies, we consider it worthwhile further investigating the reasons for our current economic situation.

According to the study, the root of the problems is to be found in the errors of the economic policy and in the malfunctioning of the institutional system. Analysis of economic development in the period since 1968 and especially of the eighties shows that our economic troubles are mainly caused by domestic economic factors, malfunctions due to the rigid production structure that only slowly adjusts to the new requirements, and the practice of economic policy and economic management diverging from the declared principles. The economic policy and system of institutions developed in 1968—the development of which was hindered by several factors—did not prove to be flexible enough to adjust to the changed conditions in the world economy. Following the restriction introduced between 1979 and 1984, it appeared as if there was balance in the economy, while the severe structural and efficiency problems emerging earlier and still existing today were hidden behind this appearance. The fact that the resolution of the CC of the HSWP in October 20, 1977 on structural policy remained basically unimplemented also played a role in this.

The root of the problems appearing in 1985–1986 is mainly to be found in missing the chance for structural transformation in the seventies, in the behaviour maintaining the economic structure, which slowed down the reform process between 1972 and 1978 and in opting for general acceleration of economic growth; while between 1979 and 1984 this behaviour resulted in the introduction of an overall restriction instead of selective limitations, which blocked the development of profitable and efficient enterprises. In the meantime, in the name of the desired development, there were too many and often contradictory priorities accepted (making development more dynamic, anti-inflation policy, modernization of the production structure, external balance, full employment, raising the standard of living) which the economic policy could not possibly handle. The problems with priorities in economic policy became even more pronounced by the contradiction between the steps taken by the economic management, which anticipated the existence of market relations, and the actual lack of market relations which the same economic management failed to develop.

In the opinion of the panel, one of the mistakes of recent economic policy is the series of rash, unjustified interferences in the economic processes and of operative decisions incompatible with the essence of our system of economic management. These interferences were not able to substitute for the missing market effects, and resulted in significant economic damage and distortions in attitudes concerning future development, as well as undermined the trust between enterprises and the government. In many cases measures contradicting the goals of reform were introduced with the rhetoric of the reform, causing not insignificant damage to the spirit and credit of the reform.

On the surface, the problems manifest themselves in the insufficient ability to export and in the repeated deterioration of the international payments position of the country in the past two years. However, the significant deficit in foreign trade and the large-scale deterioration in the terms of trade are only the mirror image of the evaluation of the the Hungarian economy's performance on international markets. Behind it there is the out-of-date and slowly changing production structure, and an economic policy not enforcing adjustment.

The suggested solution

"Change and reform" suggests an overall reform as the solution for the current situation. The positive aspect of this attitude towards economic policy and economic management is that it exceeds the narrowly defined economic questions and makes references to the social consequences of the measures; but it does not make definite suggestions for the solution of social tensions.

The Economic Panel agrees on many points with the essence of the concept described by the authors, but it does not consider several suggestions and solutions as possible to carry out.

According to the study, in the short run a crisis-preventing consolidation programme is needed, and the transformation of the production structure, as the precondition for long-term development, should be carried out at the same time. The precondition for consolidation and development is the establishment of a genuine yet socialist market economy, and a social environment rewarding entrepreneurial behaviour, able to tolerate conflicts originating in market selection and having the drive to succeed. All this cannot be perceived in the framework of a reform limited to the economy only, the reform must be extended to the whole superstructure.

In agreement with the authors in principle, the members of the Economic Panel also consider the acceleration of the reform process and major changes in economic policy necessary. In the view of the panel's members, major changes are needed concerning the more consistent implementation of our own principles and the formulating of new tasks in an overall programme. We must prepare a series of reform steps that can start a new period in the process started in 1968, among more favourable international political conditions than at that time. Emphasizing the necessity of major changes does not, however, mean repudiating the earlier general political goals.

We have accomplished significant results in the reform process as well, but now we need a more fundamental, deeper change than ever. In the current period the reform must cover a wider circle of state and political decision-making—i.e. the organizational and institutional system—it cannot be limited to the narrowly defined economy. Political and social reform is inseparable from the major change in the economy which, in turn, is the precondition of avoiding crisis.

Consolidation and progress

In accordance with the statement of the CC of the HSWP on November 20, 1986, the current situation requires—in addition to the acceleration of the reform process—the preparation of a consolidation programme covering the period until the end of the decade. The task in this consolidation period is to eliminate the contradiction between meeting the long-term goals of economic policy and the short-term necessities at the same time. The programme of actual tasks must be prepared without delay. The aim of this consolidation period is to utilize all external and domestic resources for the transformation of the production structure that will result in higher competitiveness. For this we need such monetary and budgetary policies that, keeping the requirements for balance in mind, assist the firm restriction of domestic income utilization (i.e. consumption and investment) and the utilization of investment resources for selective purposes that result in the increase of exports. They must also assist the utilization of foreign resources for this—and only this—purpose, mainly in the form of direct foreign investment. Due to all this, halting the increase of debt can be set as a realistic goal only for the early nineties. The number one aim of economic policy must be the transformation of the economic structure based on market selection and on the preferred technological progress which will result in higher income earned in both the external and the domestic market. We must consider very thoroughly whether we can afford to have additional priorities weakening this main goal.

The transformation of the economic structure can only be successful if the excessive reallocation of incomes through the budget is reduced. The conditions for this can be established basically by the gradual elimination of loss-making production and products. More vigorous steps are needed on both poles of the current production structure; the elimination of unprofitable activities should be accelerated and the chances of pioneering enterprises to develop should be increased. We must put an end to the belief that all production can be made profitable.

In the view of the panel the main aim, i.e. the structural transformation and the maintenance of our international solvency, can only be achieved if the reduction of domestic income utilization will not be carried out with a further overall restriction concerning investment by enterprises, and if we make sacrifices in the field of state expenses, certain central development programmes, standard of living and employment policy in the transition period. A decline of the standard of living and transitory structural unemployment probably cannot be avodied; this is a necessity originating in the logic of interrelations. It is important to emphasize, however, that the unfavourable social and economic impact is not the consequence of the needed measures. The panel believes that the lack of these imperative steps—positive transformations without changes in the long-term tendencies—would threaten us with an even lower standard of living and other negative social consequences.

In addition to the concept of a social policy adjusted to the system of the socialist market economy, in order to minimize the necessary sacrifices a socio-political and social policy programme is needed that is able to tackle the negative side-effects. This programme should decide how big the unavoidable sacrifices can be, who should be affected and what sort of guarantees can be given. The preparation of this programme is also necessary in order to avoid measures—the economic impact of which is minimal—that increasingly irritate the society, as has happened many times in the past few years.

Possible methods

Because of the lack of genuine market relations, the system of economic management has only tried to simulate the logic of the market so far, but has not been able to introduce real market selection. The panel considers it absolutely necessary to aim in the competitive sector at the consistent implementation of the principles of the socialist market economy in the new period of the reform. However, it needs to be emphasized that while in the competitive spheres of production and services a market based socialist economy needs to be developed, where market co-ordination dominates, and where the dominant means of central management are methods influencing the market, the non-market sphere, where processes will not be regulated by the market, will still remain significant. Such an area is, for example, the majority of infrastructure. In these areas, too, increased attention must be paid to the return of costs, except for activities whose priority is justified by social policy considerations. While we will make definite attempts to develop the market, the reform will still have to be based—in accordance with the principles announced in 1968—on the organic and efficient unity of plan and market.

By one-sidedly emphasizing a strict monetary policy the study has simplified the nature of the problem to an extreme extent. The authors rightly criticize the current budget (fiscal) policy for directly influencing the economic processes by taking on demand-regulating, market-substituting roles, while in implementing structural policy it overburdens the credit system. Monetary restriction is, in fact, a suitable means of restricting the aggregate excess demand, and for starting the process of efficient transformation of the economic structure: but it is not possible to regulate all processes by these means only. The state cannot give up its co-ordinating role. It is not possible to decide on questions like the general development strategy of the economy or of infrastructure, foreign economic policy or harmonizing interests, etc., on the sole basis of the market.

For similar reasons, national economic planning cannot be degraded to the means of preparing a "mainly ... a macro-level financial programme". (p. 204)

In the study a concept is outlined that wishes to replace the current governmental planning co-ordination process—which needs to be improved—by a market-type (monetary) and democratic coordination of interests. While not questioning the necessarily increasing role of market-type and democratic co-ordination, we must draw attention to the necessity of up-to-date (integrated) governmental coordination together with these, because otherwise the basic strategy of economic policy cannot be devised. In absence of this the planning and special interrelations designed to represent the objective laws of the economy can be pushed in the background in the process of democratic conciliation of interests and, as a consequence, conflicting interests concerning distribution will be solved at the expense of the external balance.

The legitimate criticisms concerning planning repeatedly warn of the necessity to renew the system of planning and to reconsider its time horizons, scope and methods. A financial approach, as opposed to one in-kind, must play a much larger role in the process of planning. A more open, more flexible system of planning must be developed that is able to incorporate the impact of the market.

A precondition for the success of the necessary changes in economic policy is that we reconsider the instruments of economic management according to a uniform concept; as opposed to selecting some of the individual means and placing their transformation on the agenda, while leaving the rest untouched. Uncoordinated decisions, dissipated over time, concerning the interrelated questions of tax- and price reform, wages- and income regulation, the institutional system etc. will weaken a successful implementation of the economic policy.

In Hungary today, among the methods to be applied for influencing the economy, the tax system is seen as playing an important role. The system of taxation on its own cannot be expected to bring about structural changes but, if it is correctly adjusted to the priorities of economic policy and if we let it operate, it can successfully contribute to achieving the goals of structural policy. The panel sees the main significance of the system of taxation in that it—together with a suitable price system—helps the clear assessment of the situation and the correct evaluation of the profitability of different activities and, on this basis, it allows for the preparation of a more sophisticated structural policy and with this for the development of more profit-sensitive and cost-conscious enterprise behaviour.

The members of the panel believe that the study is also correct when it addresses the directions of development concerning the socialist market economy, the modernization of central planning activity, the increased role of monetary measures and the tax reform that was decided upon earlier. They consider it important to elaborate the exact methods and their form that can assist the more powerful assertion of market forces, the structural transformation and the consolidation itself in the period of consolidation.

Reform of ownership and enterprise organizations

The panel considers the question of ownership and enterprise organization timely. In the past few years, the party and government management have been the initiators of modernizing the enterprise organization, creating a larger variety of forms of enterprise management that, all in all, were remarkably successful. Further developing of the reform requires further progress in this field as well, but the solutions suggested in the study must be better coordinated with our socio-political and economic goals and possibilities. The starting point of the study's suggestions is the correct argument that the spread of ownership forms based on long-term interest in increasing capital rather than on interest in the annual profit only, and the significantly increased number of participants in the market and the creation of a market atmosphere where the individual actors of the market can emerge, develop and even stop existing, are preconditions of real competition. To achieve this they believe the reform of state ownership necessary, in which state ownership would be replaced by economic units deciding about their own properties; thus the foundation rights now belonging to the state (government administration) would be taken over by the enterprise collectives operating in a self-managing form. In this way the enterprise collectives could become shareholders and, at the same time, such ownership organizations could be formed that are exclusively interested in the increase of the capital assets of society.

In this part of the study elements of ownership and operative state and enterprise management are presented in an excessively intertwined and theoretically questionable manner. Shareholding companies suggested as the general form of ownership can be founded in a limited number only. The genuine shareholding (joint stock company) form and the ownership rights practiced by the enterprise council, as they exist today, are irreconcilable. In the case of joint stock companies it is not the collective or its elected body which has the ownership rights and control over the management, but the meeting of shareholders and the executive board. This will not be changed even if the members of the collectives become the owners of shares with small value.

The question of what to do with successful private enterprises must be answered.

If we want private entrepreneurs to invest their profit in the expansion of their enterprise, they must receive institutional guarantees that they can—up to a certain limit—grow. In addition, there should be solutions found for transforming the enterprises exceeding these limits into social property in the form of some sort of mixed socialist–private capital association, also acceptable for the private entrepreneurs.

In order to abolish monopolies and to increase the number of participants in the market significantly, the panel believes that limited organizational decentralization is necessary, depending on the type of activity. This will mainly consist of the decentralization of monopolistic organizations that gain advantage by their monopoly position, abuse their position and those that do not operate profitably. It disagrees with the argument that association forms and enterprises, as the basic organizational forms of social ownership, will become democratic by their publicity and openness. It would accept an argument according to which widely defined social control is also a precondition for real social ownership—which is not identical with state ownership. It also agrees that the forms of ownership must be diversified, and the rights of the enterprises to ownership, extended. Interest must be established in the long-term increase of capital and—mainly by increasing the number of small- and medium-size enterprises—the number of participants in the market must also be increased. In order to do this, the possibility of founding modern trading associations (joint stock companies, limited liability companies, etc.) should be extended to domestic and foreign legal entities and natural persons in the form of simple registration by the Court of Registration. The number of forms from which state enterprises can choose must be increased, too.

The Economic Panel agrees with the suggestion that the forms of ownership must be developed, and gives its support to any investigation and analysis that contributes to the creation of new forms, improving and transforming the current ones.

Political reform—the leading role of the party

The panel agrees that the progress of the reform is interrelated with public thinking and the system of political institutions. We must make progress in the field of public openness in the framework of political reform. It is important that no decisions should be made concerning wide strata of the society without including the public. If we fail to work out a mechanism—matching the logic of the matter—in both politics and economy, there will be mutual distrust. In order to avoid this, the minimum requirements of security for both the economic units and the citizens must be prepared, the guarantee for which could be increased openness. Although past experience of the reform shows that these changes are initiated from above, their implementation cannot be completed without concurring and active support from below, something that can only be obtained by appealing to the public at large. The successful completion of the reform requires the mutual effects and dialectical unity of this two-way process.

Although the panel is, in principle, in agreement with the necessity to modernize the political and economic mechanism, it believes that the actual suggestions of the study require a different approach. Some of the suggestions concerning the socio-political sphere set requirements that have either been met already, or there are solutions being prepared in similar a spirit. Thus the new election law, more precisely, the preparations to delimit the role of the Parliament and the Council of Ministers, serve the purpose of wider democracy. There are some suggestions in the study that deserve consideration, and some where we can agree on the need for change but not on the suggested solution. However, the relations of political organizations and the reform must be clarified by preparing further, more detailed legal and administrative alternatives. The study signals the problems rather than suggesting professional solutions for them.

The panel believes that in order to solve these tasks we must face the fact that the modernization of the party and government management is necessary. As part of this modernization, the tasks and methods of cooperation among party, government and interest representing organizations must be settled more unambiguosly than before, and the weight of elected bodies must increase at the expense of the administration. The precondition for responsible cooperation among different bodies and organizations operating in the political system is that they become independent and can publicize their views and standpoints before the actual decision-making. In this way there can be more room for democracy, and it can be clearly seen what sort of compromises the decision needed.

The panel agrees that the role of the Parliament must be strengthened in merit, and the authority of the Presidential Council, which substitutes for that of the Parliament, should in fact be revised. It does not, however, support the formation of parliamentary groups around members who have individual electoral programmes. Constitutionality must be improved by enforcing the principle that everything not forbidden or limited by law should automatically be free for persons and economic units. The actors in the economy should not be called to account with non-economic methods if they use this possibility.

The situation today makes the adjustment of the political style and leading role of the party to the tasks of our age and to the current requirements an important task. The policy of the Patriotic Peple's Front must be reconsidered and further developed. The leading role of the party must manifest itself in a new way and be strengthened in the framework of a wider political alliance. This is absoletely necessary in order to strive against the increasing apathy and to win the support of those with different views.

There can be reform thoughts but not a reform process without the party. It is politics that is responsible for the preparation of a social strategy, and making decisions on economic policy in harmony with that and assisting its realization. The panel therefore considers it important that the party elaborate its own views on ownership, the conciliation of interests and economic constitutionality, social policy, and the state and political mechanism.

In addition to maintaining and strengthening its leading role in the society, the party must take on the new tasks necessary for the progress of the reform process, and the political management of processes aimed at solving these tasks. Without the party the absolutely necessary, real and comprehensive programme cannot be implemented, even though during this programme unpopular measures cannot be avoided. The party must organize and lead the work that—in accordance with our socialist principles and system—shows a way out of the current situation. This must be the simultaneous achievement of further progress in reform and economic consolidation. In order to make the reform process wider and more complete, the path to participate in politics must be open for the whole public; initiatives from below concerning the meeting of tasks must be appreciated, along with the social responsibility originating in this.

In the panel's evaluation the authors of the study contributed with their creative thoughts to the common search for the way out, and some of their suggestions should inspire us to look for different solutions. The publication of the study serves the awakening of the society's consciousness to the problems, as well as the better public acceptance of the necessary changes and the unavoidable sacrifices.

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FROM THE DEBATE ON PERSONAL INCOME TAX

PERSONAL INCOME TAX IN HUNGARY

Along with the further development of the Hungarian system of economic control and management, the system of taxation of enterprises and households is to be radically transformed from the 1st January, 1988.

That means the introduction of a general turnover tax of the value-added type, and of a personal income tax. At the same time, today's enterprise taxes and those levied on the population will be abolished or newly regulated.

The proposed Hungarian personal income tax system grants exemption up to a certain bracket to every citizen (yearly Ft 48 thousand), and above this limit progressive graded rates will be applied (from 20 to 60 percent).

Tax reliefs

—Wage and salary-earners receive an employee benefit of yearly Ft 12 thousand, deductible from the highest income band;

—Small-scale agricultural producers' incomes are taxed on a family basis, with a yearly tax-free amount of Ft 500 thousand;

—Whatever promotes technological development (inventions) is granted relief; tax reliefs are also granted to members of liberal professions (writers, artists, etc.);

—Special reliefs are granted to those saving for, or buying, a home or an apartment;

—a linear "sources tax"—not combined with others—is imposed on incomes from interests and dividends;

—Pensioners are granted tax reliefs on their income above their pension—the pension itself remains tax-free.

Various kinds of incomes are tax-free, mainly social benefits granted by the central or local government to citizens by right of citizenship or because of need (family allowance, scholarships, welfare aids, etc.).

The entire tax reform and particularly the introduction of the personal income tax are subjects of lively disputes, which is due to the present regulations, as well as to the long prevailing economic views.

In today's income regulation, incomes of the population are subject to a dual system of regulation:

—In the sphere of state-owned and cooperative enterprises, outflowing labour incomes are dependent on rules based on the enterprise's tax-bearing capacity (practically depending on profit), whereas the *personal* income of workers earning such income is regulated by the progressive superannuation (pension) contribution.

—Incomes earned under market conditions (individual and joint ventures, secondary occupations, liberal professions, etc.) are practically regulated by demand and supply, and on the *individual's* income a general income tax is levied.

Since the incomes earned in those two fields (incomes subject to superannuation contribution are exempt from the general income tax), it is worth "mixing" the incomes subject to the two different kinds of regulation, because in this way the average burden is lower than if the source of income were exclusively the main occupation, or exclusively the market venture.

From the aspect of taxation, what the personal income tax is intended to bring about is exactly "equality": not to make any distinction between main (full-time) and secondary occupation, employment or market venture, but to impose identical rates on identical amounts of income.

The personal income tax imposes an additional burden only on incomes that are to be combined, not taxed in this way before, since

—It will be prescribed with binding force that employers' net income earned in their main (full-time) job cannot in effect decrease (that personal income tax will be integrated into the wages, and will substitute for a series of today's enterprise taxes, for example the wage-tax paid by the employer);

—In individual and joint ventures, the entrepreneurial and personal income tax replacing the company tax and general income tax will result in almost the same measure of tax burden.

The shortly outlined Hungarian system of personal income tax is attacked from many sides, of which the most important are the following:

—The proposed system does not take into account the number of dependants, leaving the problem to welfare policy;

—Progressivity is feared to have a curbing effect on outputs;

—The obligatory raising of wages and the introduction of progressive taxation may exert a strong inflationary pressure.

These are the main points at issue in the two polemical articles published in the following.

(M. K.)

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PERSONAL INCOME TAX, YES–BUT HOW?
(Contribution to debated issues)

I. GERGELY

In the economic reform process an important role is assigned to the tax reform, and within the reform, to the introduction of the personal income tax. As for the latter, a number of unsettled issues have been raised in the course of professional debates, and written about in various periodicals. My contribution is an analysis of the questions that can be interpreted in the light of international experience, with a view to the eventual effects of the reform.

International experience

The personal income tax system in its present form goes back about a hundred years. In the beginning, it was of a low percentage, but in the course of time (in particular during the 1950s) it has risen considerably.

There basic tendencies prevail in its practice:

—In the *Scandinavian* countries income taxation and social welfare policy are closely connected. Income tax is progressive, low incomes are complemented with "negative tax" (social welfare aid), and considerable tax-reliefs are granted to families (depending on the number of dependants), to the elderly, and to the needy.

—In the *Anglo-Saxon* countries, tax burdens are lower. Welfare aids are granted, as well as the discretionary tax reliefs required by the high standards of social care for families.

—In the *Latin-European* countries, on account of low tax-morality, taxation is based on the indirect i.e. turnover and consumer taxes rather than on personal income tax, since the former is easier to control.

Recently, the principles as well as the practice of personal income taxation have been harshly criticized by economists, politicians and practical experts in the advanced capitalist countries. As a result of their criticism, changes are being considered, mainly in respect of lowering the progression of taxes, and simplifying the entire system of taxation; in the United States and in Great Britain government measures have already been made in this spirit.

Personal income tax is an organic part of the tax structure of the capitalist countries, and an important source of revenue for the budget. Therefore, the abolishment of the personal income tax is not considered a realistic proposition, though the charges made against it go almost as far as challenging its right of existence. What are those objections?

—The rather costly operation of income taxation requires an army of specialized and reliable *officials,* and thorough control.

—Income tax elicits massive resistance, institutionalizes *distrust* between citizens and the tax authority, and it also hurts citizens' autonomy; whereas it is unable to function without due cooperation on the part of the citizens, i.e. their keeping records and making yearly declarations. Because of the taxpayers' contrary interests, this cooperation must be enforced administratively.

—It causes social *tension* due to the fact that income tax weighs much more heavily on wage-earners than on other groups of society, and that higher-income beneficiaries frequently make use of a number of tax allowances.

—Tax systems are inextricable and frequently change, and this has a *destabilizing* effect.

—The personal income tax has the unintended, yet steadily strengthening effect of increasing *tax avoidance* in the informal (black or shadow) economy.

This undermines tax-morality in general. The functioning of the tax system is connected with *bargaining,* which cannot be eliminated even by the most sophisticated methods of modern electronic registration and control of finances.

The development prospects of the Hungarian economy

At the present time, economic policy debates in Hungary are centred—to put it bluntly—around visions of a stagnating or a dynamic economy.

The vision of a *stagnating economy* is based on the assumption that the structural deficiencies of the Hungarian economy, and its slow reaction to world market changes cannot be substantially altered. In the spirit of these forecasts, we should be resigned to the fact that, under the present difficult world economic circumstances and in an era of increasingly sharp international competition, we are unable to achieve a genuine improvement of our situation. The Hungarian economic structure is so rigid and the debts are so high, that they make the evolvement of a structural adaptation based on accelerated technological development quite impossible. The inherited rigidity of the economic structure, and the reproduction of loss-making activities would make the maintenance of "tax pressure" inevitable for some time yet, as well as the need for a strong and differentiated central taxation of enterprise incomes—consequently, there would be no way of gradually reducing the difference between national income produced and distributed.

On the other hand, the vision of a *dynamic economy* is based on the assumption that, even under changed world economic circumstances, determined and well-thought-out initiatives may lead to a considerable improvement of the capacity and efficiency of the economy. The mobilization of existing reserves, a clear preference for competitive activities, and due redistribution of available resources would create such conditions of operation which encourage a better economy and would be sufficient, without generating a new wave of investments, to lift Hungarian economic life out of its depressed state. Resources-forming creative energies could be released for a gradual livening up of development-investment activities and, relying on these, the Hungarian economy could start on its way to structural renewal. For this end, an employment and incomes policy is needed which will encourage individual and collective efforts towards establishing a dynamic equilibrium.

The question is: in which way are the above-mentioned alternatives affected by the introduction of the personal income tax? International experience warns us that the personal income tax—its unfavourable side-effects unmitigated—*may counter economic policy efforts aimed at a dynamic growth of the economy*. Namely, the introduction of the personal income tax in the manner it is envisaged involves the following risks:

—the progressive nature of the tax will *dampen* much of the initiative there is to enlarge socially profitable activities;

—as against *socially* organized wage-earning activities, people will be even more inclined towards complementary incomes which can be earned in the *second economy*. These activities are hardly or not at all controllable, and they will lead to a dissipation of the people's energies;

—the *battle* fought against financial organs and tax authorities may sap considerable energies from productive and creative work;

—the personal income tax, in its envisaged form, may impede the assertion of equal chances and the *democratization of society*.

Demographic policy—family protection

Taxation alone is, of course, unable to resolve the problems of social welfare policy. However, international experience shows that practically all forms of income taxation take into consideration, in one way or another, the level of family composition and their social situation. It seems that in this respect the planned Hungarian income tax system will be the only exception. This is even more questionable, since the birth rate and the number of marriages are falling whereas the number of divorces and childless families is growing in Hungary. The death-rate is high, even though free health care is available in principle to everyone by civic right. Further, almost a quarter of the population is in a handicapped position, needing support (old, disabled, sick). Yet the envisaged income tax is not based on the family but, instead, on individual income. It does not take into account in any form dependants and family costs, despite the fact that the state only undertakes the smaller part of the costs of maintenance of dependants. Therefore, there are wide differences in the burdens of maintenance weighing on families (i.e. on the wage-earning family members), so that highly different living standards—and tax-bearing capacities—may belong to identical levels of earnings. Also, it is to be feared that

—increasing economic tensions may further narrow down the scope of certain social benefits and reduce their real value;

—the—otherwise desirable—reduction of consumer price subsidies, and increased freedom in market price formation may considerably increase families' financial burdens in social care;

—higher studies, the development of individual talents, and health protection will be hindered by the increasingly expensive services, while also the income tax will reduce families' net incomes.

To sum up: I find it an alarming trait of the planned income taxation that it does not promote demographic and social welfare policy objectives, but instead, counteracts them.

Controlled and legal incomes

It is a much criticized facet of the capitalist income tax system (some authors simply call it a trickery) that it formally gives equal treatment to the income of wage-earners and to that of independent entrepreneurs, whereas in fact recorded wages (controllable by the wage-sheet) are taxed higher than the less easily controllable incomes. Even in the Anglo-Saxon countries, with well-established traditions of taxation and famous for their tax-morality, the efficiency of taxation is estimated at 95 percent with wages, and only at 65–70 percent with incomes from entrepreneurship and capital. In Hungarian society, the justification for taxing wages will remain questionable as long as we are unable to assess incomes that are not on the wage-sheet and are thus uncontrollable. A general and proportionate sharing in taxation infers the *legalization and control of complementary income producing activities prior to* a general introduction of the personal income tax.

The Hungarian banking system has taken only the initial steps to promote *money-sparing forms* (i.e. cheque books and bank accounts) of payment among the population. Cash payments from pocket to pocket make it impossible to control declared incomes through consumption.

In the capitalist countries, the practice of taxation is based on the fact that economic activities are really widely legal and controllable. The hundreds of thousands of small enterprises and undertakings and the family enterprises are all tax units. The second economy is extremely large in Hungary—it is estimated that 40 percent of incomes are earned there—and a considerable part of private activities are concealed. In respect of taxation, the acknowledgement of private notes and records is not unambiguous. The shortage economy has entailed certain ambiguous, tacitly accepted forms of activity which cannot be controlled by taxation. For example, in the field of private home-building, the fruit and vegetable trade, private foreign currency turnover, contractual catering and trade, lawyers' extra incomes, etc. (to say nothing of the "classical" tip-enjoying activities). That part of today's second economy that can be made legal and controllable must be regulated, and clearly separated from illegal activities. This is the precondition ensuring first, that the socially necessary section of the second economy can be brought into the tax net, into the general and proportionate taxation; and second, that those engaged in these fields should not be surrounded by an atmosphere of suspicion, nor threatened by arbitrary actions of the taxation apparatus, which would constrain them in their activities.

Labour market and income tax

As the rates are known and analogies are available, conclusions can be drawn with regard to the probable effects of the planned taxation. It is known that the progressive tax will weigh more on high, and less on low incomes. The so-called "zero-balance" may be established at around the average earnings or the subsistence level. Since, in Hungary, it is the typical case today that a higher-than-average income can be earned by the use of more than one source, the tax burden of higher-than-average incomes will be increased not only through the progressive schedule, but also by the adding up of different kinds of personal incomes—the total income will then be included in a higher income bracket. According to my computations, if the planned system of taxation is introduced, those who earn an income sufficient for the living of a typical Hungarian family will come near the bracket assessed at 35–40 percent, and thus their average tax burden would be about 20–25 percent. (The "engrossing" of incomes* would compensate for only a part of this, so that the *diminishing of net real earnings* would grow into a *mass* phenomenon.)

The personal income tax could raise tensions in a few other fields as well, such as the so-called shortage trades. It is well known that in these trades it is difficult to keep

* Meaning that wages and salaries of 1987 will, in principle, be increased by the payable income tax. — Ed. note.

and replace labour, even at relatively high wages: this is so in particular in mining and public utility services. The cutting down of subsidies may bring about a situation in which enterprises will be unable to grant, from their returns, wage increases ("engrossing"), which are wanted for compensation of the personal income tax. As a consequence of the restructuring of incomes, performance may fall, and migration increase. These problems will have to be solved in one way or another. So this is to say that *the mechanisms of plan bargaining, price bargaining and regulation bargaining will be followed now by the mechanism of personal income tax bargaining*. Tax exemption, reduction, and compensation may elicit a chain-reaction: it may become a subject of bargaining to decide which sphere of shortage activities should benefit from the exceptions.

Another generally known problem is that the various fields of income earning offer alternative prospects of labour utilization to workers. Thus, on account of the disparity of incomes in the first and the second economy, specific output is generally lower in the (full-time) occupation, and the specific income level is higher in the second economy. I am afraid the personal income tax will further increase this tension. Namely, it is easy to control wages in the primary (full-time) occupations of the *socialist* (state and cooperative) sector, whereas the complementary incomes earned in the second economy are uncontrollable. Thus it will be even more worthwhile to work on one's own account, and even less rewarding to make efforts in the full-time main occupation.

It should not be left out of account, either, that *workers are not interested in increasing their income at any price*. They may react on the introduction of the personal income tax by different strategies; typical attitudes may be the following:

—In low-income groups less burdened with progressive taxes, outputs may not be affected by the taxes.

—Those in the higher-rate brackets of progressive taxation will feel that their additional output is regressively remunerated, and they will start manoeuvring with outputs, i.e. withholding performance that they feel is not duly paid for. This *withholding of performance* causes the worse social damage, especially in the more important fields of activity—but in any case, it is a loss to the economy.

—The withholding of performance can be prevented if the loss of income suffered because of progressive tax is *compensated through wage increases*, yet this raises production costs, deteriorates competition on the microlevel, and further strengthens inflationary pressure on the macrolevel.

One of the typical manoeuvres of workers will certainly be that they will prefer alternative prospects of earning incomes, such as those which have a lower chance of being taxed, or those where money earnings are easier to conceal (invisible).

—The philosophy of "instead of a higher income, let us have more leisure" may become popular also in Hungary; it is found to be a general accompanying phenomenon of progressive income taxation. The usual forms in which this philosophy materializes are the *refusal to undertake extra tasks,* the use of non-paid holidays, growing sick-lists, suspension of a trade, etc.; all such schemes being with a view to preventing achievement of the bracket felt to be unbearable.

—There will be families whose burdens deriving from an earlier started housing investment will be *cumulatively* increased by the new *tax provisions* (property tax, income tax). The inevitable reaction of households will be either "shrinking", i.e. forced selling and underconsumption, or "compensation", i.e. running after complementary incomes. None of these—in my opinion—can be called a desirable type of reaction.

Enterprise attitudes

On the surface, enterprises "have nothing to do" with the personal income tax. This seems so, however, only at first sight. The introduction of the personal income tax does indeed affect enterprises and they will consider its probable and real effects. One of the effects will be that workers will expect enterprises to compensate them for the progressive tax burdens, by granting wage increases. In the course of the wage-bargaining, therefore, the way of compensating the yearly *growth in tax,* and the treatment of the special tasks (taxes entailed by night shift, extra hours, end-of-the-year rush) will become important elements.

A consequence of this wage bargaining may also be the intensification of bargaining about prices and subsidies. It may be, therefore, that what is made up on the roundabouts (personal income tax receipts) is lost (or even worse) on the swings (because of increased subsidies from the budget). It can be expected, too, that enterprises will strive to increase the ratio of fringe benefits.

Fringe benefits from the enterprise

Enterprises' cash and in-kind benefits have different objectives, forms, and sizes. Their last assessment, claiming to be complete, was made in the 1960s. A survey of fringe benefits is almost impossible today, partly for lack of data, and partly for the theoretical ambuiguity of the nature of these benefits.

In the capitalist countries, a part of the benefits is treated as a wage, and taxed in the same way as wages. Thus the money value of the benefits is added to the personal income and is a part of the tax-base.

During recent years in Hungary, mainly on account of efforts at avoiding the constraints raised by the enterprise wage regulation, the sphere and extent of incomecompleting benefits—granted by enterprises to relieve individual and family budgets—have been growing. The introduction of the personal income tax is likely to intensify this tendency, since *enterprise benefits* may become an instrument of tax-free provisions over wage.

Typical fringe benefits include the refunding of travelling costs, cheap canteen meals, educational aid, cheap holidays, various in-kind benefits (coal), preferential purchases (food, textiles, etc.) and so on. These forms of benefits, to be accounted with the enterprises' general overhead costs, have been in use so far.

It is characteristic of the fringe benefits granted by enterprises that their sphere, size, and entitlement are not clearly settled. Their tax-compensating and wage-completing function is made more expensive by their complicated distribution mechanism; some are burdened with considerable costs of administration. Besides, they can fill their compensatory role only through over-compensation, since benefits must be granted not only to those formally entitled to them. In many cases, the form of utilization is restricted: in-kind benefit cannot, or only partly, be converted in conformity with effective needs.

Taxation of top managers' benefits

One of the characteristic features of the income taxation system functioning in the capitalist countries is that there are tax allowances accompanying the progressive taxation of high incomes, from which only privileged persons may benefit. There are a few special differences within the general tendency. In the Scandinavian countries, for example, a number of legal possibilities (and tax allowances) are not used, on ethical grounds. In the United Kingdom, certain enterprise benefits are tax-free for workers, whereas they form part of the tax base of managers. In the United States, the tax allowances of the special benefits have recently been curbed on several occasions, yet privileges and tax allowances are still widespread.

In Hungary, the planned system of personal income tax does not take into account this question at all, even though ways are still open to giving preferential treatment and special benefits to managers. Although the reserved shops have been abolished, and privileges curbed, the techniques of obtaining preferences by means of mutual favours have spread further and become even more sophisticated.

Because of bad memories from the past, there is general aversion towards the advantages and benefits enjoyed by the privileged. The conditions that allow managers to enjoy conspicuous benefits in excess of their income give rise to growing antipathy. These benefits are generally known, yet not made public, so that they are, as a rule, over-estimated. This, however, does not change the fact that the advantages, privileges and benefits form a part—direct or indirect—of the *personal income*. If there is no reason to abolish them, they must be *taxed*.

Housing costs and personal income tax

The personal income tax is not a family tax, but in its intended form it will be a burden borne by families. In Hungary, the majority of parents are motivated primarily by the need to create adequate housing conditions for themselves and their children. The burdens of this task become heavier and heavier all the time. The earlier 70 to 30 percent proportion of state and private home-building has reversed, and the price index of building and furnishing costs has risen above all the other groups of costs.

The planned personal income tax system contains certain elements supporting young people's advance savings for housing, while it does not recognize the indispensability of parental assistance. Yet, without considerable assistance on the part of parents, relatives and acquaintances, in today's Hungary it is almost hopeless to buy or build a home and furnish it. All this is totally ignored in the planned system of taxation, as is the circumstance in which the housing problem repeats itself or grows with the increase in the size of the family. The burdens arising therefrom are in no way taken into account in the proposed system of taxation. A just system should by all means have consideration for the fact that the acquiring of a home costs the total 10–15 years' earnings of a family, and also recognize the enormous difference between those forced to buy a home and those *having a rented home*. The latter, namely, enjoy in fact *tax-free fringe benefits and tax exemptions through several decades.*

Wage regulation and personal income tax

The relation between enterprise wage regulation and personal income tax is, as yet, unclear. According to many, the personal income tax will at the same time *regulate purchasing power*, so that a separate central wage regulation will become unnecessary. According to others, the separate regulation of the enterprise wage outflow cannot be dispensed with.

It is characteristic of the existing wage regulation system that in a certain sphere of enterprises wage outflow is related to profitability, whereas in another sphere, enterprise wages depend on central decisions. In fact, the wage-paying capacity of the majority of enterprises is not constrained by actual profitability, but is, instead, determined by the title under which economic management acknowledges the right to support the enterprises' wage demands. Enterprises' wage competition for obtaining and keeping labour—now to be continued on the "gross" (tax added) wage level—will intensify the spirals of wage-wage and of wage-price, and even those of price-price, and price-wage. If, with a view to counterbalancing the effect of the personal income tax, enterprises increase wages by means of fringe benefits, the state's standpoint on the matter will have to be clarified.

The wage regulation system repeatedly undertakes the impossible task of minutely regulating enterprise wage development. I am afraid that the income tax will not only fail to promote a more incentive and efficient wage regulation but, on the contrary, the wage-raising effect of the tax will entail a restriction of the wage regulation.

Inflation and the dynamics of taxation

In Hungary, controlled inflation has been incorporated into economic policy. The rise in nominal wages follows—on the given level of productivity—the rise in prices only after some delay. Since in the second economy the majority of incomes have been growing faster than prices, *the income gap between the two economies has grown wider* and it is realistic to expect that *it will grow even wider*—and this will in no small way be due to the tax.

In connexion with the tax reform, one must also expect that the cost-increasing effect of the government taxes will lead towards, immediately or shortly, to a rise in prices.

—On the labour market, a strong demand will emerge for *wage increase* to (partly) compensate (or in some cases, over-compensate) the personal income tax—the effect of which will inevitably spill over onto *prices*.

—The probable growth of the second economy (as a result of efforts to avoid taxation) also promises to have a *price-raising* effect.

—Price increases will certainly react on the labour market, creating pressure for a faster rate of increase in incomes. This will lead to further price increases, i.e. to the acceleration of the *inflationary spiral*.

Inflation challenges the progressive rates of tax. (It is one of the reasons, why several countries have adopted linear rates.) Since the tax on the income of a given year is paid at the beginning or middle of the next year, a high inflation rate can reduce the tax revenue in real terms. In the long run, if the earlier set of progressive rates is not corrected although the nominal rise in the income level will result in an increased nominal revenue, the real tax growth will be reduced by inflation. That means *the progressive personal income tax will not conform with inflation*. In this respect, it causes further difficulty in that:

—it is difficult to have the *tax rate schedule* accepted, but even more difficult to alter it;

—incomes grow at different rates; therefore, the changing of the rate schedule *affects* the different social groups *to a different extent* (i.e. the incidence changes), which raises questions of compensation;

—the changing of the rate schedule will spill over onto prices to a different extent with the different groups of products. This then also *affects the wage-earners' living standards* to different extents;

—the progression of tax, following inflation, will turn the earlier wage-price spiral into a tax-wage-price spiral, and will thus intensify the whole situation.

Relative costs and competitiveness

The personal income tax will shift the proportions of production factors, make labour more expensive and thus, in principle, technology cheaper. The effect should be the encouragement of investments. In practice, however, this influence asserts itself only if enterprises are interested in scrapping equipment, which has been written-off as being of zero value, and are in a position to purchase more up-to-date technology. For this, investment sources are missing today, and the prospects of imports are scarce. Therefore, it is worthwhile to keep technologies depreciated in comparison with wages, which makes "expensive" standstills, and the low utilization of machinery capacities less conspicuous.

It is a well-known fact that after 8–10 years of use, it does not pay to renew or repair old production eqipment. Most of the existing fixed equipment is in need of a second or third cycle of renewal. In many cases, renewal is more expensive than the purchase of new technology. The upgrading of living labour, "gross" wages, personal income tax, and renewals by casual contractors or by the enterprise economic work teams (similar to western entrepreneurial groups) will further sharpen this contradiction. All this would further deteriorate Hungary's *international competitiveness.*

Illegal incomes

A part of the income earned in the second economy can be transformed into controllable, legal income. Another part cannot—and the situation with this is the following:

—if every useful activity pursued in the second economy can be given a controllable and legal form, *illegal* activities *pursued without licence* will be not only taxable, but also *penal;*

—bribes paid and received in order to overcome unnecessarily complicated central prescriptions will not be declared as this would be equal to self-denunciation;

—incomes originating from *bribes* and the obtaining of special advantages can only be *detected*—which is made more difficult by that part of these appear in legal forms (for example, presents, etc.);

—*damage done to social property* will probably increase with the introduction of the personal income tax; and, since it is a penal offence, nobody will confess to such action, either.

Distrust

The capitalist countries' taxation practice has certain traditions. Although the tax authority is far from being popular, its expertise and reliability are not doubted. In the Scandinavian and Anglo-Saxon countries where relatively high, linear taxes are applied, tax authorities which proceed according to the "rules of the game" are accepted, since they respect civic rights and a tax court functions. Politicians take care to protect the well-intentioned taxpayer, who is also an elector.

In Hungary, the mutual distrust of state and citizen has traditions going back to the Hapsburg-era, and this is still fed by retroactive, mistaken, offending, superficial, ambiguous and misinterpretable measures.

The proposed extent and progression of the personal income tax are high by international standards. Such rates are applied in the countries where the tax authority has reason to assume that the majority of the citizens are not to be trusted in relation to taxation. Therefore, high rates must be applied to counterbalance the fact. It is, however, a better solution to create conditions in which the tax is objective, and the taxpayers are judged on equal grounds. Otherwise, those who have acquaintances in the right place will fare well, as well as those who find the person with whom a bargain can be struck. No tax controller can be posted against each taxpayer, and a super-controller against the controllers...

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At the present point of time, the most important thing is to restore economic equilibrium, and to revitalize the economy. The way to recovery is to increase efficiency, i.e. to improve performance. This end should also be promoted by the tax reform.

The tax system of the 1950s was a "double-channel" system. Households were charged by turnover tax through consumer prices, and enterprises by profit tax. The tax reform of the 1960s redistributed tax burdens through a "multichannel" system, through taxing production and sales, living and embodied labour, households and enterprises. At present, tax weighs partly on materials and primary energies, the direct consequence of which is that the budget gets revenue prior to effective realization. This weighs heavily on enterprises, and hinders the evolvement of self-financing.

With a view to the future, a tax reform is needed in which the main end is the *increase of* performance. This infers the reduction of budgetary expenditure, the abolishment of central loss-compensating subsidies, and the simplification of the institutional system. One of the important basic principles of the tax reform is a fair distribution of the tax burden over society. Therefore, multichannel taxation will have to be further developed in conformity with the nature of a "mixed economy".

In consideration of the resistance to tax, and of the different "production costs" of the various kinds of taxes, it will be worth setting up a hierarchy of the proportions of the tax categories within the tax reform.

The turnover tax is a firm and simple source of revenue. Of its three forms, the production tax of the basic materials and primary energies could be reduced—yet it might harm the cause of economy (material saving), which is not satisfactory, anyway. The role of consumer taxes, to be realized in trade, may be increased to some extent as a function of the price system, the living standards policy and the consumption policy.

With such preconditions, an equitable and stable system of enterprise taxation could evolve, such as can promote intensive development of the enterprises. As for the system of personal income taxation, it could be developed, in my opinion, under the following principles:

1. *Performance principle:* the tax burden should be reasonable; the rate schedule should not be sharply progressive. It is well-known from experience that strongly progressive taxes exert a prohibitive effect, leading to fall of performance and even to decline of activities.

2. *Equity principle:* taxation should support the founding of families, and take into account the consequences for social welfare policy.

3. *Justness principle:* the assessment of personal incomes should cover all: and it should conform to the principles of social justice.

4. *Confidence principle:* Taxation should be based on mutual trust: the government should clearly lay down the rules of recording incomes, and protect the decent taxpayer. At the same time, it should take firm action against transgressors and evaders of tax liability.

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PERSONAL INCOME TAX: PRINCIPLES AND DEBATES

M. KUPA

In his article "Personal income tax, yes—but how? (A contribution to debated issues)"* István *Gergely* specifies the disadvantages and weak points of the personal income tax system and, at the end, lays down certain principles which ought to be taken into consideration in working out the system to be introduced. I agree with these principles.

Nevertheless, I wish to state in advance that there are a number of statements made by István Gergely with which *I do not agree*. However, before starting to polemize, it will be useful to elucidate the basic principles and main characteristics of the taxation system now under elaboration, and about which a debate is going on—albeit irregularly and in a narrow circle.

According to a party and government programme, a *tax and price reform* is being worked out in Hungary, and it will affect enterprise and personal taxation as well as the entire system of producer and consumer prices. In conformity with the further development of the entire system of economic control and management, the reform is aimed at developing such tax and price conditions which, as an economic policy means promoting economic recovery, can help to create a more favourable environment for autonomous (risk-taking) enterprise management. These conditions will also increase profit- and cost-sensitivity, they are nearer a realistic system of values (reflecting efficiency and real profitability in processes of production, consumption, investment, exports and imports) and, last but not least, they can render price and financial conditions simpler and easier to understand for individuals, economic units, and economic policy-makers.

A further important aim of the tax and price reform is to transfer a considerable part of the net income realized in the national economy from the sphere of production to that of end use (i.e. consumption) and to reduce producer and consumer price subsidies. This end is also promoted by the introduction of certain new kinds of taxes—such as a general turnover tax (value-added tax), and personal income tax—which are *neutral to organization and sector*. This means they are assessed on products

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(and services) independent of the organizational type and sector, in both cases disregarding the place of manufacture or purchase; they are also assessed on (personal) incomes regardless of the situation of those earning the income. All such assessments are to be based on uniform principles and norms.

It is an important characteristic of the changes that the resource-proportional taxes realized at present in producer prices (property tax, wage tax, and the greater part tax on earnings) will be eliminated. The coverages for the eliminations will be partly built into wages to counter-balance the personal income tax, and partly spent to reduce the producer price level, which will enable the increase of the general turnover tax to be realized on products and services in end use. As a result of the restructuring of taxes and the lowering of the producer price level, the relative prices will change as well. Thus also the profit level will be lowered, and this will in turn enable moderating of the linear tax levied on profit.

After the tax reform, economic units will have to pay only social insurance contributions (according to a flat rate), and profit tax. In this way profit will be the basis of incentive and taxation in all fields of the economy, including the food economy.

Producer and consumer prices will be connected by the new and normative general turnover tax, which will operate with a low number of rates.

The lowering of the producer price level and the changes in the relative prices allow the abolishment of various kinds of production subsidies. The new normative general turnover tax system—which makes the changes in the relative producer prices felt in the consumer prices—will necessitate, along with adequate compensation, a cutting down of the economically unjustified consumer price subsidies.

Lower producer prices, and the fact that the general turnover tax does not charge the producer's consumption (i.e. in that case tax is a transit entry), exports and investments, represent an export incentive. Further, they will make investments cheaper, which helps the establishment of healthier relative proportions in the valuation of living and embodied labour from the viewpoint of development.

The personal income tax is an important element in the transformation of the enterprise tax (and price) structure, since it can substitute approximately Ft 40–60 thousand million of direct enterprise taxes (wage tax, etc.). Without its introduction, the taxation of enterprise profit could not be reduced to any considerable extent. In other words today's income regulation system (of enterprises) would have to be maintained or, if today's direct enterprise taxes were substituted, the revenue thus lost would have to be compensated through increased turnover taxes. When the new tax and price system is introduced, the enterprise income-regulation system based on tax bearing capacity will be abolished and replaced—presumably— by wage regulation based on the reconciliation of interests, existing today only in outline form.

It is expected that these changes will put into a favourable position efficiently working enterprises actually paying normative direct taxes today, while they will have an unfavourable effect on economic units working with low efficiency—most of them at the moment being exempted from direct taxes and enjoying high favours. This restructuring according to differences in performance will probably help to improve the structure of the economy and thereby accelerate efficient development.

Therefore, the personal income tax is not simply a new type of taxation of the population, but much more than that: it will be one of the fundamental elements of the envisaged tax and price reform, the probable socio-economic effects of which are being examined in minute model computations.

The main principles of the planned personal income tax

The personal income tax system under elaboration displays the following principal characteristics:

The personal income tax is levied on the individual, (personal) yearly income (without regard to sources and with separate incomes combined) under a progressive schedule, as shown in the *Table below:*

The envisaged rates of the personal income tax

Income bracket (1000 Ft)	Tax rate of the bracket percent	Average tax burden in the middle of the bracket[1] percent	Necessary completion of gross income[2] percent	Distribution of those employed in the state and cooperative sector[3] percent
48	0	0	0.7	23.1
48– 66	20	0	2.0	20.0
66– 90	25	1.5	5.2	24.1
90–114	30	9.4	8.1	14.0
114–144	35	13.8	12.8	9.4
144–180	40	18.3	17.9	5.1
180–240	45	23.7	24.4	2.9
240–360	50	30.9	35.8	1.1
360–600	55	39.2	53.1	0.2
600–	60	49.3[4]	69.8[4]	0.0

[1] It also contains the employees' yearly allowance of Ft 12 thousand. (That is to say, up to Ft 60 thousand per annum the average tax burden amounts to "0".)

[2] The average wage increase necessary to maintain the net after tax earnings, computed with 7 percent of linear pension contribution.

[3] Computed at 1988 level, in a situation following the introduction of the personal income tax.

[4] Computed with an average of Ft 1 million.

— *Wage and salary earners* can, *as a favour granted to them*, reckon yearly Ft 12 thousand tax-free, counted from the top. (For example, with an income of Ft 190 000, the tax base will be Ft 178 000, of which 48 000 tax-free, and 130 000 scheduled by the corresponding rates.) The reduction of the tax base "from the top" affects the "section of income" rated the highest, with a view to incentive of performance. (Also the narrow brackets shown in the Table act against holding back performance, since passing into the next bracket does not entail a steep rise in the marginal tax burden.)

— In the system to be developed, the treatment of certain types of income is still at issue.

— As for the tax treatment of the personal income of *small-scale agricultural producers*, two different positions exist. Both depart from the point that the change in the taxation system should not diminish the propensity for production. One view, held by the majority of experts, is that the income earned in small-scale agricultural production must be combined with the rest of the taxable incomes, while maintaining—and even increasing—today's reduced-rate taxation. According to the other view, small-scale agricultural production must be treated separately from the personal income tax, as it is today.

— The tax treatment of incomes from *savings* (interest acquired from savings books and bonds, dividends paid on shares and special shares is also at issue. Such solutions must be found as are apt to encourage *permanent and regular* forms of savings, while bringing into harmony the taxation of incomes from savings with the taxation of incomes from other sources, such as from labour or enterprise. (If the yields of savings are tax-free, it leads to tax avoidance on the one hand, and it works against the yields of other taxable savings, such as enterprise savings, on the other. It thereby distorts the pattern of capital investment, and finally, it is politically unacceptable to prefer "riskfree" incomes to other personal incomes.)

— Grants (benefits) in money *depending on earnings* will be treated in two different manners by the tax system. The amounts of sick-pay and child-care allowance* will be "engrossed" to account for the tax and then be regularly taxed, so that the net amounts will *not* change in comparison with the conditions prior to introduction of the tax.

Pensions are rated at "0", that is to say, pensions are tax-free, independent of the amount. If, however, the pensioner earns a complementary income, his pension will become part of the tax-base. The Ft 12 thousand reduction counted from the top is granted also to pensioners. (If, therefore, someone draws a pension of Ft 80 thousand per annum and earns an additional Ft 40 thousand in the given year, in the tax treatment of the latter amount, an income of 120 (80 + 40) thousand must be taken for

* An allowance now granted to mothers until the child reaches 18 months of age and amounting to 71 percent of previous wage. — Ed. note.

a basis, minus the tax-free 12 thousand. Thus the tax-base will be Ft 28 thousand. Its rate: on the Ft 80 thousand pension 0 percent, in the 80 to 90 thousand bracket 25 percent, in the 90 to 108 thousand bracket 30 percent—all this totalling 2500+ 5400=7900. At the same time, the worktime and income limitations of pensioners' employment will be lifted, and no pension contribution will have to be paid on the complementary incomes.

— Allowances in kind from central or local government (education, health, etc.) are not subject to taxation, nor are grants in money payable by citizen's right or because of need (family allowance, child care aid*, educational grants, aids, scholarships, etc.).

— Up to a certain limit, the tax-base can be reduced by the amount of advance savings for housing, and the instalments and interest rates paid on credits raised for the purchase of a dwelling or home.

— A preferential tax base is stated in the case of activities promoting technological development (patents, inventions, etc.), and artistic activities.

— "Invisible" incomes (gratuites, tips, etc.), are added to the tax base.

— When income taxation is introduced—and, later on, every 3 or 5 years—, a property declaration must be made to enable control of the incomes declared (also in respect of the "invisible" incomes!).

— The present progressive pension contribution will be replaced by a flat-rate contribution.

— Entrepreneurs (individual and associate) will also pay a linear *entrepreneurial* tax in addition to their personal income tax.

Principles of the transition to the new tax

The net earnings of those employed by state and cooperative organizations in primary full-time occupation will, on average, not diminish. (The controversy is about whether the "engrossing" of wages i.e. the addition of the payable tax, should be on the individual, or on the enterprise-institutional level.)

— The net nominal earnings may diminish in the case of incomes coming from various sources, because of the combination.

— Social benefits are not to be restructured by the taxation system: their real value must not fall as a consequence of the tax and price reform.

— The *model computations* set out from the assumption that the real income positions of enterprises and individuals (enterprise' investment purchasing power,

* Not identical with child-care allowance. It is paid to mothers after the child has reached 18 months of age and is a fixed sum much lower than the child care allowance, payable for another 18 months — Ed. note.

personal real incomes) are, *on the whole*, not to change because of the tax and price reform, and the balance position of the budget cannot be modified. The *actual situation* will be determined, of course, by the prospects and demands of the yearly national economic plan.

The expected impacts of the personal income tax system

Expectations in the field of societal policy:

— it should create conditions in which there is due information, *registration*, and aggregation of incomes;

— it should thereby enable that social benefits be allocated on more objective grounds;

— tax payment should be a general duty of citizens earning regular incomes;

— tax burdens should be in proportion with incomes;

— the tax system must be in conformity with the social political, social welfare, demographic, and housing policy objectives of Hungary.

Expectations in the field of economic policy:

— the new tax system should enable reduction of the enterprises' direct tax burdens;

— it should enable the regulation of households' purchasing power to be made uniform, and thus today's income regulation system can be abolished;

— it should contribute to a uniform evaluation of living labour;

— it should not impede increase of performance.

It is, further, expected that the tax system be simple, clear, and easy to understand. Employees' incomes are taxed by means of deduction, and incomes arising from various sources will be assessed on the basis of declarations.

Open issues

In his article, István Gergely voices his numerous worries, making reference to international experience and to the probable functioning difficulties of the personal income tax system which is, as yet, not quite worked out. I will not counter all the points he makes which seen questionable to me; but I must remark that some of the problems mentioned (wage regulation, enterprise behaviour, the income-earning "strategies" of workers) are rather well-known phenomena under the prevailing conditions of regulation—whereas it is quite incalculable, in which way these would develop within the framework of the new system of conditions.

In the following, I shall proceed in the same order as István Gergely does in his article, as he gives no summary evaluation, nor sets forth a system that would function better than that of the personal income tax.

1. *International experience.* — In the countries where personal (or family) income is taxed, taxation is indeed the subject of incessant debates (and election fights among political parties). Yet none of these countries have the intention to *abolish* this kind of tax, simply because no better or more appropriate method has yet been invented for the regulation of personal incomes.

— Turnover (consumer) taxes and the personal income tax are complementary but not substitutive. Turnover taxes regulate the consumption *pattern* of the households' spendable income, while income taxes regulate their *magnitude*. (It is true, though, that incomes concealed from taxation can only be caught through the turnover tax.)

— Tax systems tend to progress towards simplification. It is mainly tax allowances that are "rearranged", the number of rates that is reduced, and the magnitude of the rates are even lowered. Yet the tax bill does not diminish. (For example, in the United States, the simplification and lowering of the tax rates were accompanied by the abolishment of most of the allowances, so that the tax revenue increased as a result.)

— Another point which can be made, relying on international experience, is the one according to which taxation demands specialists and expensive electronic equipment. Yet it is to be noted that the tax apparatuses are at least self-financing (the revealed cases of tax avoidance and evasion can amply finance the tax apparatus; this is so even in Hungary) and that, in numerous countries, the gulf of distrust lies between defrauders and decent taxpayers: tax evasion is a subject of public contempt—though, of course, not in the Latin countries.

2. The development prospects of the *Hungarian economy* can be judged in many different ways. Although the question of "stagnation" or "growth" certainly cannot be solved by the tax system alone, there is no doubt that today's system of taxation and subsidies, marked by a restrictive economic policy, are not pointing towards development—but rather they stand in its way. The new tax and price system outlined in the introduction is intended exactly to promote development, or more exactly, to create the economic environment required for development—if by no other way than the force of necessity.

Taxation is apt to create a more solid background for the spreading of entrepreneurial activity (including state and cooperative enterprises, since it is there that entrepreneurial attitude is to be developed in the first place), because:

— organization-neutral taxes can strongly narrow down the intertwining of central economic management and enterprises, and the application of exceptional rules (the personal income tax and the general turnover tax are such organization-neutral taxes);

— the personal income tax itself ensures that the differences between *spendable* incomes be only of an acceptable extent for the society;

— thereby the way is opened for a differentiation of gross incomes corresponding to economic performance, which is necessary and even indispensable for development;

— a uniform taxation of the entire population may help the separate income regulation of entrepreneurs to be abolished, which will strengthen the mood of enterprise rather than weaken it. It is to be noted that in Hungary a wide variety of enterprise forms and activities began to thrive at a time when rate schedules were much higher than those suggested today for personal income tax (they are still valid), whereas the entrepreneurial disposition has still not abated. It is true that a progressive schedule withholds outputs, especially if income brackets are not adequately stated, or if progression is too steep. The schedule presented, with the tax-free amount and the allowance counted from the top, is intended exactly to mitigate this effect, as is shown by the average tax burdens. (The same thing is indicated by the distribution of those employed in the state and cooperative sector.) As regards the enumeration on p. 285, those phenomena are still there today, so they could not be counted as consequences of the new tax.

As long as workers are not "decently"paid in their main (full-time) job *as a consequence of* the existing wage and income regulation, and the different conditions of taxation and regulation even "drive" workers towards the second economy (a truly restrictive regulation has been asserted with regard to earnings), it is to be expected that complementary incomes remain more valuable. As for the personal income tax, it does not differentiate between the two ways of earning an income, and it is to be hoped that enterprises will have a "uniform" wage base, treated under the same principles, whether payment is made for work accomplished during working hours, or for that of the economic work team of the enterprise (working after legal worktime).

The operation of taxation has, of course, to be learned, yet it seems to me unfounded to say that it "may sap considerable energies from productive and creative work." (Members of the enterprise economic work teams, and the "simple" employees of shops operating under a lump-sum contract system have understood taxation fast enough.)

Inequality of opportunities in the earning of incomes and in the rules and tax burdens attached to it is precisely the characteristic of today's regulation. Depending on the different forms of income regulation (affecting the level or increment of earnings, or central, etc.), on the branch of economy (see, for example, the gross income regulation in the food industry), on the form of ownership (socialist, i.e. state or cooperation, or private), and on the kind of income (main, full-time occupation, enterprise economic work team, household farming, leasing of holiday-house. novelist's income), the value of labour is different even in the case of *identical* *performance and identical qualification, etc.*, and its sharing in taxation of personal incomes does not wipe out all these differences, but—from the aspect of taxation—it certainly improves equality of opportunity.

An open and uniform personal tax system is more likely to strengthen than to impede the process of democratization. The direct-tax-payer citizen is certainly more strongly motivated to "speak up" in public matters than the one who pays tax indirectly, through economic units. In the final account, the difference consists in taxing the surplus product produced by the economically active population by "more obvious" means, i.e. through personal incomes, instead of by means of enterprise taxes.

3. I fully agree that the new tax system must not adversely affect demographic processes and the situation of families. It is another question, as to whether demographic policy and family protection should use the means of the taxation system, or other means are more useful and expedient. Several aspects must be examined in order to settle the question.

— *Question of sources.* It is true that the existing systems of central and local government benefits are losing their value; the real value can only be maintained with a few grants in money, and within a narrow sphere. Beside the errors of the present system, which needs to be somewhat modernized, this is fundamentally rooted in the inadequacy of resources available for the national economy. (Without any new taxes, more could be spent on demographic and social welfare policy, were there adequate and constantly-growing "free" resources available. This is not to be expected now or in the near future. The existing resources can be, of course, redirected from wage-earners to the inactive.) Therefore, the question is whether, in the new tax system, a *higher amount of resources* is available for such purposes, or, if dependants are favoured by the new tax system, whether the revenue thus lost can be compensated in another field.

The personal income tax transforms part of today's direct enterprise taxes into personal taxes. The personal income tax revenue from the state-owned and cooperative sectors is "perfectly" identical with the amount of the unrealized enterprise taxes, exactly because the old net earnings are identical with the new net earnings—which is the purpose of forming the "gross" wages. In this way, therefore, no additional resources will be obtained. *Additional resources* will be obtained, however, from the aggregation of incomes, leaving housing policy, artistic policy, etc. allowances *out of consideration* (these are reducing factors!). This amount can indeed be used (also) for demographic and social welfare policy objectives. It remains to be decided, whether this additional resource will be spent on such objectives within or without the tax system. I shall revert to this subsequently.

No other additional source will be obtained for the budget according to the computations made so far—considering that also price effects have to be compensated.

— *Question of allowances for the dependants.* Under the prevailing social–political principles and systems, dependants receive maintenance from the state by their personal right (family allowance, pensions, alimonies, educational grants, etc.) independent of the per head family income in their family. (Independent of the financial situation of the family, children are "worth the same" in families earning high, and in those earning low incomes; married women not gainfully occupied are disregarded in today's system of benefits, etc.) Social policy is, therefore, "aimed at" the dependant, and measures the dependants of the same "category" by identical "measure". (This conception may be challenged, but in any case, it is the essential basis and the practice of today's system, "obligatory" also in taxation.)

Within the system of taxation, dependants may be favoured in different ways. One must start from the fundamental principles that the systems are to be operated so as to conform with social justice, are to be—as far as possible—uniform, and are to be available for each dependant. Dependants may be granted benefits, for example, through *percentage or fixed-amount* deductions from taxable incomes. The percentage allowance—either from the tax base, or from the tax itself—is socially unjust, since the higher the income, the higher the deduction. A fixed-amount benefit is more just, since in this way dependants (for example, children) receive the same amount, independent of income.

The social policy "benefits" within the tax system infer, however, that every income is taxable from the first forint, since there is no other way to assure that every citizen entitled thereto should indeed receive it. However, the tax system proposed treats Ft 48 thousand per annum tax-free for every person, this being exactly in line with a social policy consideration (the average per capita income of 40 percent of Hungarian households is below this level). Therefore, it would be precisely the population *in need of it* that could not receive social policy benefits within the framework of the tax system. To put it more clearly, they ought to be granted negative tax (benefit) to put them into an identical position with tax-paying citizens.

The granting of an allowance that is socially just—such that it covers everybody and is if a fixed amount—would, however, entail huge administration and complicated accounts (at least in the case of children). Yet this can be "substituted" by the well-proved family allowance. It is precisely for this reason, even though ways are being sought for applying the dependants' allowance within the tax system, that the additional revenue arising from the combination of incomes is to be spent on raising the family allowance. (Of course, the effects of price and income are also to be treated together in this case.) Therefore, the additional tax receipt obtained from the combination of incomes flows back, in its entirety, to the population, i.e. to families with children.

Let me emphasize once more: in order to increase the financial basis of the Hungarian demographic and social policy, either *additional resources* are needed, or the existing resources must be redistributed at the expense of some other objective (perhaps real wages, education, or enterprise subsidies?). This is a question for economic policy-makers.

4. As regards the disadvantageous position of *controlled and legal* incomes—as compared with incomes to be assessed exclusively on the basis of declarations—one can say that this is indeed the basic question of every tax system.

The proposed Hungarian system will also be struggling with this difficulty, yet it will not—and cannot—make use of the delusion the capitalist countries apply, i.e. the placing of an increased financial burden on wage and salary-earners rather than on entrepreneurs. On the contrary, the proposition *gives preference to the employees* (in fact, a Ft 60 thousand per annum income is tax-free due to the employee's preference, and this affects more than a third of the employees of the state and cooperative sector), whereas entrepreneurs' incomes *are subject,* beside the personal income tax, to a linear *entrepreneurship tax*, to be paid on the total income.

In order to improve declarations, *general* tax liability is first of all needed (no tax-morality can exist without a uniform tax system), and second, such techniques (and control) of taxation, which can motivate proper taxation. The general turnover tax to be introduced parallel with the personal income tax, with its refund system based on *accounts*, provides for higher incentive and improved control possibilities. Yet the perfection of tax-morality is a long-range task, and progress in this field is also dependent on such factors as the spreading of personal bank accounts.

5. What is said about the relation between the labour market and the personal income tax (pp. 273–274) attributes a number of phenomena to the tax system, which exist, however, quite independent of it.

Today's Hungarian economy does indeed suffer from shortage in certain trades (and probably always will), yet it is not because of taxation, but because of the relative prices and wages in a given field. (If a good or service is wanted, its price or wage has to be paid. If this is not recognized by economic policy, it will not be changed through taxation.)

Labour market regulation and the recognition of demand-supply proportions are not questions of taxation, either. However, the relationship between employer and employee assumes certain new characteristics under the taxation system. The employer calculates gross wage (cost), whereas the employee is interested in the net (taxed) income, and not only in what he can earn at that given job, but also in the combined total forming his net income. Therefore, he will try to optimize his earning activity, and will drive a harder bargain in the course of wage negotiations, if his main (full-time) job is his only source of income.

As regards tax, net incomes earned in a main (full-time) occupation within the state and cooperative sector are not to diminish on average in the course of the transition (under the system of conditions of the model worked out), whether those incomes are high or low. In the course of its operation, the system may "increase" or "decrease" the combined incomes as compared with earlier times, depending on the rate bracket the progressive schedule puts them into.

It is true that with incomes not combined today, yet combined within the new system, the net nominal income, perhaps also earnings, might decrease. (Real wages may decrease because of the rise in consumer prices in a given year, and not because of the rise in taxes.) Yet, what the principle of general and proportionate sharing in taxation (and of equal opportunities) demands is exactly that identical amounts of income be identically taxed—whether they come from one or more sources.

The problem of today's double wage level (main, full-time occupation: low wage, low performance; second economy: high earnings which can be concealed —high performance) may be eased by the personal income tax:

— first, the aggregation of wages will bring the gross incomes in the two "sectors" (forms of ownership) closer together:

— second, the strictness and rigidity of the wage regulations, which presses heavily on the main occupation today, can be eased;

— finally, citizens will measure and evaluate their own income position on the basis of their combined, total income.

As for individuals' reactions, they are incalculable, and one can only guess possible outcomes. (In international literature, a general withholding effect on performance and growth is not known.) Citizens' "income earning attitude" is motivated by quite a number of other factors beside tax, such as consumer needs (needs and possibilities), different chances in earning incomes, motivation and necessity of income earning, social and family situation, changes in prices, etc. All this taken into account, the reactions mentioned by István Gergely (withholding of performance, wage pressure, etc.) may, however, occur.

In my opinion, what can be expected as a rational attitude is that people will compare their extra incomes with the related extra taxes and will decide, relying on this comparison, whether to continue working or "withdraw". Individual reaction also depends on how long it will take the taxpayers to learn "to manage" under the new system.

A rate schedule of low progression—with not too steep rises between the brackets, the allowance granted from the top, and preference of intellectual activities (inventions, arts)—may hinder performance—reducing effects with the most active. (The question again arises: up to what size of income does society (i.e. politics) wish to encourage such activities, or, from which limits does it hold their growth undesirable?)

7. *Enterprise behaviour* is not determined only, and not even primarily, by the personal income tax, but by the regulation of enterprise earnings on the one hand, and the intensity of profit incentive on the other. The latter, i.e. the strength of profit incentive, acts exactly towards "bridling" the wage costs. With adequate price limitation the profit can be increased by holding down costs, or by coordinating

performance and wages. Therefore, in judging demands for wage increase, enterprises may display different attitudes, depending on their market situation.

It is, however, highly probable—and in this respect István Gergely is right—that extremely hard battles will be fought between enterprises and the government in the year of the introduction since, when producer prices are corrected for the tax system, enterprises will certainly strive for over-compensation and hoarding. This will be so that their producer prices and, consequently, their profit should not diminish to the "prescribed" extent. In the fields enjoying allowances and exemption today and in which there is no tax coverage for the "engrossing" of wages, economic units are likely to fight for central subsidies instead of reducing profits or costs, or mobilizing labour. This is a real risk and, therefore, the "engrossing" of wages and the restructuring of producer prices must be centrally organized and effectuated.

8. *In respect of fringe benefits and top managers' benefits* (p. 274), I share the author's view. It is true that if these are left *untouched* by the tax system, it would lead to "legal" tax avoidance, i.e. an ever-increasing part of wages and incomes would be transformed into such types of benefits. In our conception, these benefits will not be taxable. Instead, they will have to be frozen in the year in which the tax system is introduced, and then revised. That part which can be incorporated in the wage must be transformed into a money wage, and that part which cannot must, as far as possible, also be made subject to taxation.

9. Conceptions regarding *housing* were set forth in the introduction. In the new taxation system, family savings for housing may be deducted from the tax base, if those concerned opt for a clearly delimited and favoured form of savings.

The difference between the burdens of privately owned and rented housing is recognized in the new house-tax provision; it is not the task of the personal income tax. (Capitalized yield is not considered an income; protection of substance is favoured by the house-tax.)

10. The personal income tax system will enable today's wage and earnings regulations, which is attached to tax-bearing capacity, to be replaced by a new system (conciliation of interests through sanctions). (Regulation of the wage level fulfils the same function with enterprises today, as personal income tax will in respect of individual incomes: it imposes progressive rates on incomes; it regulates the entire income and not the increment.)

Of course, the personal income tax *alone* cannot replace wage and earnings regulations (this would infer a progressive schedule which would be unbearable and may have to be changed each year), but it may lead to more reasonable measures and forms of wage and earnings regulation. (No doubly progressive rate can be imposed on the same income, namely, once with the employing organization, and again with the employed.)

11. The interactions of *inflation* and taxation—the price-raising effect of the

shifting of taxes and, in general, of taxes—have been a much-discussed issue in the relevant literature. The phenomena described (p. 276) are, however, nor the "offspring" of the personal income tax (not at all of the tax and price reform), but the more manifest forms of the structural inflation existing in the Hungarian economy. Tax shifting is, for lack of adequate market constraints, practised even *today*, with the existing system. Taxes on resources, and especially those on the enlargement of resources (one earnings and accumulation) prompt the enterprises to increase their profit, since this is how they can achieve the required "tax-bearing capacity". Profit can be increased either through reducing costs, or through raising prices (and subsidies). The tax and price reform is aimed, among other things, exactly at cutting out this complex price inflating effect from the economy, or at least at mitigating it.

Should personal income taxation have any inflationary effects at all, their *intensity* will be far less than the combination of the current three taxes (on wages, property + income) which are to be replaced.

In its functioning, the personal income tax itself has no inflationary effect, and for several reasons. On the one hand, the "engrossing" of wages brings first- and second-economy income closer, i.e. the *income gap* grows narrower. On the other hand, the wage pressure will be eased by the circumstance that continuous indexation is a concomitant of the personal income tax. The tax rate schedule will have to be regularly corrected by the rate of inflation. Finally, to what extent the wage pressure can be asserted also depends largely on the wage (earnings) regulation system applied.

12. The rates of the presented (planned) schedule, which is not yet the final version, cannot be considered high by international standards, they are on a medium level.

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I have polemized with István Gergely on many points and at great length. We disagree on numerous issues, yet the debate itself is, in my opinion, useful. Parallel with polemizing, I have made efforts to clarify the principles and considerations of the preparatory process of the tax reform as best as I could. I think it is important to pursue the debate on the professional level as well on the widest possible social basis: first, because it may help to elaborate the best possible solution; second, because the debate will acquaint the general public with details of the groundwork going into the preparation of the tax reform, thus helping people to understand the purpose, necessity, and meaning of this reform.

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THE DEVELOPMENT OF HUNGARIAN–SOVIET ECONOMIC RELATIONS*

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In the examination of the real processes in Hungarian–Soviet economic relations an important role is played by the determination of the actual importance of this system of relations. For this a manysided approach, the weighing of factors affecting the commodity pattern of trade, exchange rate policy, the structure of production and many others, are necessary. For an investigation of mutual advantages deriving from the bilateral relations the balance data only provide limited help, for the weighing it is also necessary to take into account the composition of exports and imports over time as well as the particular valuation system developed within the CMEA. For illustration of unsolved problems of the Hungarian–Soviet relations the author presents in detail the questions of primary energy imports and those of agricultural and machinery exports.

The importance of Soviet economic relations for Hungary

In Hungary's foreign economic relations, those with the Soviet Union are of fundamental importance. This predominant role shows in various aspects: the Soviet share in Hungarian foreign trade, the particularities of the commodity pattern, the influences on the production and organizational structure of the Hungarian economy and, indirectly, the influences on Hungary's foreign economic relations with other countries.

Hungary's foreign economic relations can be divided into two large sections and these are practically of the same weight. One consists of the relations with the OECD area and the less developed countries, and the other of the CMEA relations. Although the two sections are by no means hermetically separated, both have distinct characteristics of their own. With the OECD area and with the less developed countries, Hungary's trade is settled in convertible currencies (some of the latter being under clearing procedure);

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We could make use of only scarce published data. Most publications on the topic cannot be used for economic analysis. The ample and high quality CMEA research in Hungary avoids going into the details of bilateral relations, for authors tend to write on Hungary's CMEA relations, instead. This explains why we have given exact citations only for numerical data, while at the end of the article the reader will find the most important sources on Hungary's CMEA relations, Hungarian–Soviet relations included.

prices and terms of delivery are formed and develop according to the rules of the world market. In trade with the CMEA countries, prices follow world market prices with several years' delay and accounts are settled, with few exceptions, in transferable roubles. The transferable rouble is the common currency of the CMEA countries, and it is practically a unit of account of separated bilateral relations – namely, it is not usable in other relations. Because of the particularities of price formation and unit of account, in the bilateral economic relations between the CMEA countries, the advantages to be gained from such trade are manifest mostly on the aggregate level of bilateral relations, and more obviously in physical rather than financial terms. During the last forty years, the commodity patterns of Hungarian trade with the OECD countries compared with those with CMEA countries have shown wide differences. The pattern of Hungarian exports to the OECD is like that of a less developed country, whereas to the CMEA it is like that of a highly industrialized economy.

Hungarian–Soviet economic cooperation is embedded in the Hungarian-CMEA system of relations, and represents its central element. This set-up conforms with the internal set-up of CMEA cooperation in general. Ever since the beginning of the CMEA, bilateral relations between the small Eastern-European countries and the Soviet Union have been the predominating elements of the cooperation, while the small countries' bilateral relations among themselves have been, though not negligible, of secondary importance only.

In the following, an attempt will be made at a statistical demonstration of the role of Hungarian-Soviet relations in the Hungarian economy and in Hungarian foreign trade.

Over the last fifteen years, the average Soviet share in Hungarian foreign trade turnover has been about 30 percent in both exports and imports (see *Table 1*). With this share, the Soviet Union has been Hungary's largest foreign trade partner throughout the period. In second and third position come the FRG and the GDR: as trading partners they have held these positions since 1971. Their share, taken together, amounts to not more than about a half or, at the most, two-thirds of the Soviet share. In imports, the Soviet share is the size of the total imports from West European countries, while in exports it is the size of the total exports to the OECD area.

At this point, it is worth stopping for a moment. In Hungary's trade with the Soviet Union (and with the other CMEA countries) the prices of various products differ widely from those on the world market. Alongside this, the dollar parity of the transferable rouble can be stated by different methods leading to different results, since the transferable rouble is not convertible. During the last twenty years in Hungary, the forint value of the rouble has always been lower than that of the dollar, whereas the official quotations of the International Bank for Economic Cooperation (IBEC) – have always shown the dollar to be lower than the rouble.*

*According to IBEC quotations, the value of $1 fluctuated between 0.6 and 0.9 of the value of the transferable rouble between 1968 and 1986; whereas the Ft/$ and Ft/transferable rouble rates of the National Bank of Hungary showed $1 to be fluctuating between 1.2 and 1.6 of the value of the transferable rouble (henceforth to be abbreviated as Tr. Rbl.) (Statistical Yearbook of Hungary, Monthly Bulletin of Statistics, Statistical Yearbook UNO).

Table 1
The share of the Soviet Union and other trading partners in Hungarian foreign trade between 1971 and 1985 (percent)

Year	Soviet Union	European CMEA countries*	OECD countries	Others**	Total
		IMPORT			
1971	27.9	23.7	34.1	14.3	100.0
1975	28.6	23.7	31.4	17.2	100.0
1981	28.6	18.3	36.0	17.1	100.0
1985	30.0	19.3	38.5	12.2	100.0
		EXPORT			
1971	28.6	25.0	30.4	16.0	100.0
1975	33.0	24.6	26.0	16.4	100.0
1981	33.4	19.8	27.2	19.6	100.0
1985	33.6	18.7	30.8	16.9	100.0

*The Soviet Union not included.
**Other socialist and less developed countries.

Source: Computations relying on the computer data base of the Central Statistical Office, and of the Statistical Yearbook 1985 of Hungary.

Notes: The distribution is given on the basis of values indicated in forint, converted by the Central Statistical Office from the dollar or transferable rouble values at the prevailing exchange rate of the National Bank of Hungary.

Now, if we do not take the "Hungarian" Rbl/$ parity as our starting-point but instead accept the rates of the IBEC, the newly computed distribution of Hungarian foreign trade shows a drastically changed picture. Kálmán *Pécsi*'s computations – on the basis of IBEC rates – have shown the Soviet share in Hungarian foreign trade turnover during 1981–1983 to be not about 30 but 40 percent, while the share of the OECD countries amounts to hardly more than half the Soviet share. Time series computed with a similar method have shown that the Soviet share was smaller in 1970, being only 33–34 percent, but it has grown in the period since. However, the share of the OECD countries has fallen by a third.

For the purpose of the present analysis it is the quotation of the National Bank of Hungary that is considered suitable, since this rate of exchange reflects (though fraught with contradictions) the "relative prices" of the dollar and the transferable rouble, respectively in the Hungarian economy. Yet for our analysis it is also important to establish the fact that, as regards measuring the importance of the Soviet Union as a trading partner, the share of about 30 percent is to be accepted as one of the interpretable shares – to us, apparently, the most realistic one. The application of the rate based on IBEC quotations for examination of the distribution of Hungarian foreign trade by the different markets produces an interpretable and interesting result only in the case of comparison with the distribution of the other CMEA countries' foreign trade. According to the IBEC Tr. Rbl/$ rate the share of the CMEA countries in Hungarian foreign trade is not smaller than it is on average in the foreign trade of other CMEA countries, which are usually considered to be traditionally more strongly oriented towards the CMEA than Hungary.

The significance of the Soviet Union as a trading partner can be examined from another aspect, relying on the product pattern. Since 1971, 2/3 to 3/4 of total Hungarian primary energy imports have come from the Soviet Union. For the Hungarian economy, Soviet deliveries of crude oil, gas, coke, and electric energy are crucially important. In the early 1980s, approximately a third of total raw material (SITC 2) imports came from the Soviet Union, although at an earlier date the Soviet share had been higher. Within this group of products, Soviet supplies are highly significant in the field of raw phosphate, cotton, sawnwood and iron ore. The Soviet share is much smaller in other commodity groups of imports. A fifth of total Hungarian machinery imports comes from the Soviet Union (in the 1970s it was a quarter). The Soviet share in the total imports of semi-finished products (SITC 6) is approximately the same, but it is also decreasing. In all other groups of the SITC nomenclature, the Soviet share is far below that of the respective total imports. Soviet supplies are, therefore, rather asymmetrical: outstanding in energy and raw materials, below average in machinery and semi-finished products, and very low in products of the food processing and chemical industries and in consumer goods.

Hungarian exports to the Soviet Union are less concentrated. The Soviet share in total Hungarian machinery exports has shown a slight tendency of growth: at present it is between 40–50 percent. In the group comprising agricultural products and food the Soviet share grew steadily in the 1970s and is today nearing its share in engineering products. About 4/10 of Hungarian exports of consumer articles go to the Soviet Union, and one quarter of all exported chemical products. At the same time, industrial products which are unprocessed or semi-finished, raw materials, and energy, are under-represented.

The high share of the Soviet Union in several commodity groups of Hungarian exports and imports leads us to the conclusion that a high dependence has developed in this bilateral relation. At first sight, the dependence related to imports and the dependence related to exports seem to be of a different nature. Energy and raw materials are mass products which may be procured from several markets. Taking into consideration, of course, the important infrastructural and geographical conditions, the importer is free, in principle, to form the proportions of its main purchasing markets. As for exports – Hungarian manufactured goods – of which only a small part comes up to the quality, packing, financial, servicing and other conditions of the OECD markets – find a market for greater quantities only in the CMEA countries (among them on the Soviet market) having standards similar to Hungary. Therefore, dependence that has developed in exports may be changed much less by a decision aimed at diversification. On a closer examination of the problem, however, it becomes clear that the dependence on imports is, at present,

Table 2

Soviet share in Hungarian imports and exports according to the SITC commodity groups 1971–1985 (percent)

	0	1	2	3	4	5	6	7	8	9	Total 0–9
IMPORTS											
1971	14.9	5.8	42.5	62.5	6.0	13.8	28.4	27.8	8.2	0.0	27.9
1975	2.3	5.2	46.2	64.1	21.9	10.4	30.2	26.9	7.5	0.0	28.6
1980	1.1	3.7	30.3	71.4	0.0	11.3	23.1	24.3	5.8	3.3	27.7
1983	1.0	7.9	38.0	58.8	0.0	13.7	23.3	23.7	3.9	4.0	28.5
1984	1.1	6.9	36.1	66.5	0.0	14.6	21.8	20.9	4.0	3.5	29.1
1985	1.5	5.8	33.9	73.1	0.0	18.1	21.9	19.0	2.9	2.7	30.1
EXPORTS											
1971	16.2	42.1	9.3	7.4	0.5	38.1	15.6	41.1	45.0	0.0	28.6
1975	34.5	48.9	16.2	2.3	0.3	36.2	15.9	38.9	47.5	0.0	33.0
1980	41.0	39.3	10.3	3.3	0.3	23.1	11.9	38.1	35.1	0.6	29.3
1983	41.8	53.5	8.3	2.3	9.3	30.1	14.1	43.1	38.7	0.7	31.6
1984	32.3	61.2	7.8	2.8	0.9	27.3	13.7	45.4	38.2	3.0	30.1
1985	37.9	59.4	7.1	4.6	5.2	27.7	15.5	46.2	41.6	0.3	33.6

Source: computations based on the computer data base of the Central Statistical Office of Hungary

0 – food and livestock
1 – beverages and tobacco
2 – raw materials
3 – mineral fuels
4 – animal and vegetal oil
5 – chemicals
6 – semi-finished products
7 – machinery and transport vehicles
8 – miscellaneous manufactured goods
9 – products not classified elsewhere

based on the dependence on exports. As long as the Hungarian export supply is relatively less competitive on the markets where trade is settled in hard currency, the present extent of import dependence remains an unalterable fact. Summing up: the reduction of dependence may begin by improving the world market competitiveness of Hungarian export supply in general, simultaneously with the improvement of the conditions of export to the Soviet Union and the increasing of efficiency of the domestic economy.

Yet another aspect of the significance of Hungarian–Soviet economic relations shows in the impact of these relations on the production and organizational structure of the Hungarian economy. The Soviet Union is a country of more than 270 million inhabitants; her imports are in the hands of a small number of foreign trade unions.* Two facts follow from this: it is easier for Soviet foreign trade officials to keep in contact with a few big enterprises than with tens of thousands of small firms; second, Soviet import orders, once made, are usually of extremely large volumes. Both facts have worked towards a situation in which, in the division of labour that has developed during the forty years of cooperation, it is first of all the large-scale enterprises of Hungarian industry that have become oriented towards the Soviet market. These enterprises have mainly adapted themselves to the quality, packing, servicing, delivery-scheduling, and controversy-settling requirements of the Soviet market. It is, therefore, not accidental that it is exactly this group of enterprises which finds it most difficult to make its products competitive on the world market. The production pattern of Hungarian agriculture also shows the influence of the rising total of the previous ten years' exports to the Soviet Union; the increased production of mass produce such as grain and unprocessed meat is mainly due to the need for exports to the Soviet Union. On the traditional Western markets, Hungarian agriculture can only achieve modest results through such products.

An examination of the significance of Hungarian–Soviet economic relations for the Hungarian economy, from several aspects, leads one to the conclusion that these relations are important to such an extent that related developments may in themselves exert a decisive influence on the further development of the Hungarian economy.

The question of equilibrium

In Hungarian–Soviet economic relations, as well as in the mutual relations of the other CMEA countries, the question of equilibrium is a problem of extreme complexity, being difficult to grasp. The questions of trade balance, balance of payments, and the equilibrium of advantages to be gained from bilateral relations are almost inextricable.

The figures for the balance of payments of Hungarian–Soviet trade are not made public, so it is not possible to study separately changes in the trade balance and changes in the financial sphere. Trade data, however – which are public – contain such Hungarian deliveries which embody the interests and instalments of earlier raised credits, practically

*The recent extension of foreign trading rights to other organizations is an important step forward. However, it does not, for the time being, imply a change in orders of magnitude.

of commodity credits, which are themselves in commodities. On the import side these credits appeared, some years ago, as Soviet exports without compensation. Trade turnover data further show certain deliveries increasing the export and the import side respectively. This is a part of the joint investment, and it can be considered as another special kind of credit construction. Besides, certain financing items* of Hungarian–Soviet relations show up also in commodity trade, if the turnover in those items is unbalanced. Trade statistics also include figures of exports and imports transacted outside the clearing system, in convertible currency; in this trade there has been a considerable, – though in recent years, decreasing – surplus on the Hungarian side. Thus the data of *Table 3* show an approximate balance of Hungarian–Soviet trade.

It follows from the above-said that the balance computed on the basis of the published data of trade turnover is not suitable for drawing conclusions – especially with regard to the exact balance conditions of Hungarian–Soviet trade and even less regarding the equilibrium of advantages** to be gained from this trade. The latter would hold true

Table 3

Hungarian–Soviet foreign trade balance and coverage rate between 1971 and 1985

Years	Balance (million $)	Coverage rate (export/import, percent)
1971	– 98.4	84.3
1972	49.4	107.7
1973	74.3	109.1
1974	2.1	100.2
1975	– 49.6	96.8
1976	– 27.4	98.2
1977	– 21.4	98.8
1978	–266.5	88.0
1979	–317.0	87.6
1980	– 16.3	99.4
1981	299.2	111.5
1982	341.9	113.1
1983	317.2	113.1
1984	223.1	109.5
1985	401.0	116.2

Source: computations on the basis of the data base of the Central Statistical Office of Hungary

Note: Forint data have been converted into dollars on the basis of trade conversion factors provided by the Central Statistical Office of Hungary

*Payments related to tourism, services, incidental costs of commodity trade, etc.

**As opposed to the trade accounted in convertible currencies, the advantages to be obtained from trade in a closed clearing system are closely related to the balance of trade.

even if we were in a position to know the balance of trade computed for the clearing as well as for the convertible currency trade, and even if the fragments of the credit sphere showing in the export and import deliveries could be clearly separated.

The consideration of advantages, and efforts made at establishing an equilibrium, are at least as characteristic of the various partial domains of the turnover, as of the global trade. As a consequence of the clearing system, the unconvertible unit of account, price conditions deviating from those of the world market, and because of manufactured goods being of a lower technological standard than that required on the world market, a sphere of "hard" and one of "soft" goods have formed in the mutual trade between CMEA countries – included in this process is the trade between Hungary and the Soviet Union. Hard goods are easy to sell on the world market, and/or are import priorities of the partner country, whereas soft goods can practically be sold only on the CMEA market and/or are not among the priorities on the list of import needs of the partner country. Primary energies and raw materials, a few semi-finished goods, and lately also some of the agricultural and processed food products are traditionally hard goods; whereas the soft goods are in the sphere of manufactured products. The two spheres are not sharply divided: certain articles are hard in one year but soft in another.

The partners try to establish an equilibrium of advantages in several stages: in the course of discussions concerning (medium-term) plan coordination, in elaborating the five-year trade agreements, in composing the yearly and, to a smaller extent, also in drawing up the civil-law contracts, between the concerned enterprises. They try to do this by laying down the "hard-soft" proportions, item by item as well as globally, in respect of both parties' export supply and import need. In the Hungarian–Soviet clearing trade in which the clearing becomes an inapt provider of an adequate framework for the endeavours to equalize advantages. This is how, within Hungarian–Soviet trade, a part of advantages. In the bargaining process aimed at establishing an equilibrium of advantages, the subjects discussed are the maintenance or amendment of earlier developed soft-hard proportions, additional quantities of traditionally traded goods, and the compensation of products envisaged as future introductions in the mutual trade.

Situations may arise – mainly because of the deviations between world market and CMEA market prices, or because of the impossibility of physical compensation – in which the clearing becomes an inapt provider of an adequate framework for the endeavours to equalize advantages. This is how, within Hungarian–Soviet trade, a part of turnover accounted in convertible currency and zero-balance construction within the clearing came into existence. It is also why, in several cases, the waiving of certain export and import items took place. This, partly, explains the efforts made at joint investment.

The equilibrium of advantages is in close interaction with the commodity pattern of trade, the trends of changes in it, the dynamics of trade, and the developments in that sphere of credit which is closely connected with commodity trade. In the following, these fields will be reviewed.

Structure of the trade turnover

Important changes took place in the composition of Hungarian imports from the Soviet Union between 1971 and 1985. In 1971 a little more than a third of imports was made up of industrial raw materials and energy and 60 percent of manufactured products; this proportion had been reversed, as a result of gradual changes, by 1985. The increased weight of unprocessed goods is, primarily, to be traced back to price effects – in particular to the increased prices of energy. The share of energy trebled – at current prices – between 1971 and 1985, exceeding 50 percent in 1984. According to Kálmán Pécsi's computations (he set out from the statistical nomenclature of the CMEA), the share of primary energies was 41.5 percent in 1983 at current prices, while only 28.4 percent at 1970 prices. The share of raw materials fell by more than a half at current prices, as is made clear by the data of *Table 4.* Agricultural products were almost totally driven out. Of the manufactured goods, semi-finished products and machines – earlier making up, together, half of the imports – lost much of their weight. The share of chemicals grew dynamically through the entire period, though their absolute share did not reach 10 percent even in 1985. Industrial consumer goods only made up a fragment of imports in 1971, but their share shrank to almost zero by the early 1980s.

During the last fifteen years, the commodity pattern of Hungarian imports from the Soviet Union has grown less varied and has become polarized. The increased share of energy – partly because of increased prices – is only one of the reasons. There are other reasons, too: for example, the Soviet supply has shrank (agricultural products, a few semi-finished products, transport vehicles). The Soviet supply of engineering products and consumer goods and Hungarian import neeeds rarely match and, with some of the "hard" products, the Hungarian compensation offered has not been acceptable to the Soviet partner.

Hungarian exports to the Soviet Union comprise two major elements: manufactured goods and agricultural products. The share of the latter group has been growing fast since 1974, the year when deliveries of large quantities of Hungarian grain and meat started to be exported in the Hungarian–Soviet convertible currency trade. In the group of manufactured goods, machines and transport vehicles predominate. These groups, with their growing shares, made up, on average, 4/10 of the total Hungarian exports to the Soviet Union throughout the entire period. Industrial consumer goods also have a high share, although of a decelerating rate, similarly to that for semi-finished products. The share of chemicals has stayed at about 10 percent.

Since the group of engineering products is a most important element of Hungarian exports in general, it is worth investigating what share this group represents in Hungary's other export markets.

The figures for Hungarian exports of engineering products – shown in the Table – clearly reflect the dual character of the Hungarian economy. Exports to the Soviet Union, the CMEA countries and – to a smaller extent – to the less developed countries mainly consist of machines and equipment, whereas in exports to the advanced industrial

Table 4

The commodity pattern of Hungarian–Soviet trade on the basis of SITC nomenclature (1971–1985) (percent)

Years	IMPORTS									
	Group of commodities:									
	Total	2	3	5	6	7	8	0,1,4	2,3	5,6,7,8
1971	100.0	17.6	16.5	5.5	21.3	31.9	1.4	5.9	34.1	60.0
1975	100.0	16.1	28.0	5.1	21.2	27.3	1.1	1.2	44.1	54.7
1980	100.0	10.2	42.3	5.6	14.7	25.7	1.0	0.4	52.5	47.0
1983	100.0	9.5	47.1	6.3	13.3	22.6	0.7	0.4	56.6	42.9
1984	100.0	9.2	51.2	6.9	12.5	18.7	0.8	0.6	60.4	38.9
1985	100.0	7.8	53.6	8.1	12.0	17.3	0.6	0.5	61.4	38.0
	EXPORTS									
	Total	0	1	5	6	7	8	0,1,4	2,3	5,6,7,8
1971	100.0	12.3	3.7	10.5	9.8	39.2	22.1	16.0	2.4	81.6
1975	100.0	22.8	3.2	7.7	7.8	38.5	17.6	26.0	2.4	71.6
1980	100.0	26.5	2.8	7.5	5.9	41.7	13.3	29.2	2.3	68.5
1983	100.0	24.8	4.2	9.7	5.6	41.5	12.1	29.4	1.7	68.9
1984	100.0	19.1	4.9	9.9	6.1	45.3	12.8	24.0	1.8	74.2
1985	100.0	18.9	4.2	9.5	5.6	46.0	14.0	23.3	1.6	75.1

Source: computations on the basis of the computer data base of the Central Statistical Office of Hungary.

For words for the figures see *Table 2,* and:
0, 1, 4 – Agricultural and processed food products
6, 2, 3 – Raw materials and energy
5, 6, 7, 8 – Manufactured goods

Table 5

The share of machines and transport vehicles (SITC 7) in Hungarian exports between 1971 and 1984

Years	Soviet Union	CMEA (the S.U. included)	Less developed countries	OECD	Total
1971	39.2	38.7	31.8	5.9	27.3
1985	46.0	46.5	31.4	10.7	33.5

Source: The data base of the Central Statistical Office of Hungary and the Statistical Yearbook of Foreign Trade 1985.

countries this commodity group plays a secondary role. This clearly indicates the specialization tendency and ambiguous competitiveness of this branch of exports.

Dynamics

In Hungarian–Soviet trade accounted in roubles, the dynamics of exports and imports have tended to deviate in recent years.

The retardation of the growth of trade, and the different development of export and import volumes can best be studied on the basis of constant price figures, but the data concerning Soviet economic relations are not public. Data are, however, available on the total turnover accounted in rouble. Since the export and import patterns of Hungarian trade with the smaller CMEA countries are very similar, and this turnover is balanced, the different tendencies in the volume of the total turnover accounted in rouble (the Soviet Union included) and in the dynamics of the trade with the Soviet Union* at current prices may give, according to our assumption, an approximately reliable picture of the volume dynamics of the Hungarian–Soviet trade in its main proportions.

The Table shows that already in the years between 1975–1980, the volume of exports was growing twice as fast as that of imports. However, a really sharp difference is evident between the years 1980–1985 when, with unchanged volume of imports accounted in rouble, the Hungarian export economy had to enlarge its deliveries accounted in rouble by a third. In effect this meant, for the reasons set forth above, an increase in deliveries to the Soviet market. Therefore, as a consequence of the limited possibilities of and willingness for additional deliveries on the Soviet side, and of the gradually rising Hungarian liabilities because of the five-year averaging of prices, a one-sided expansion of Hungarian exports, measured in physical terms, has emerged.

*Trade data at current prices with the Soviet Union include, beside transactions accounted in transferable rouble, convertible currency transactions.

Table 6

Changes in the volume and value of foreign trade turnover accounted in rouble, and of the Soviet relation between 1975–1980 and 1980–1985 (1975=100 and 1980=100)

Years	Turnover accounted in rouble*		Soviet relation	
	volume	value	volume	value
		IMPORTS		
1980/1975	116.7	118.5	–	129.4
1985/1980	100.1	141.4	–	148.4
		EXPORTS		
1980/1975	130.2	119.1	–	127.7
1985/1980	133.9	167.1	–	173.5

Source: The relevant issues of the Statistical Yearbook of Foreign Trade (of Hungary).

*This category includes foreign trade with other CMEA countries in addition to that with the Soviet Union.

Credit relations

The history of Hungarian–Soviet credit relations has two clearly distinct phases. In the years between 1946–1975 Hungary received credits from the Soviet Union, not of high amounts, but nonetheless of importance because of their scheduling and conditions. The repayment ended in 1975.

A new phase began in the mid-1970s with the starting of the so-called "joint investment" procedure. As for its content, the "joint investment" represents a price increase, and as for its form, it is credit granted to the Soviet Union by Hungary and other East European countries. It manifests itself within a financial framework, but is mainly embodied in physical deliveries, the repayment of which is also made by means of goods: namely, additional energy and raw material deliveries.*

The so-called consolidation credits are even more closely related to the global development of Hungarian–Soviet economic relations; the Soviet Union has been granting such credits from the mid-1970s to the East European countries – among them Hungary – which have been struggling for a balanced turnover because of the sudden rise of import prices. The amount and composition of these credits are not publicly known.

To sum up, increasingly different export and import patterns characterize the bilateral trade relations between Hungary and the Soviet Union and within these the composition of Hungarian imports has shifted towards the predominance of energy.

*These credits granted to the Soviet Union indirectly increased Hungary's debts in convertible currencies, since some of the Hungarian deliveries consisted of goods financed with Western credits.

Three key fields of the bilateral relations

Hungarian efforts to counterbalance bilateral trade have led to continuously increasing export volumes, while the volume of imports has stagnated. According to the system of valuation which is peculiar to the CMEA, the advantages measured by contrasting hard and soft goods has shifted towards the Hungarian partner. However, if the situation is viewed from outside this system, it can be seen that increasing the supply of extremely dollar-import-intensive export commodities was in fact a serious trial of the capacity of the Hungarian economy – for this process took place without any impulses being received from the Soviet market to induce structural changes which might have led to a modernization of the economy. On the contrary, they have encouraged the development of the production of commodities that are not even expected to become competitive on the world market.

In the following, three fields of Hungarian–Soviet economic relations will be discussed. These alone are sufficiently important to determine the development of the system of relations as a whole and, beside that, they illustrate most of the obstacles standing in the way of any further development of cooperation. Thus such obstacles can be more palpably demonstrated in this way than in an abstract manner.

The question of energy imports

During the fifteen years between 1970 and 1985, the world economic role of primary energies, and especially of crude oil, changed radically. From an important strategic article, oil grew to be, after the two price explosions, a product capable of bringing about a thorough transformation of the earlier relations of the world economy, with its price determining the long-term development course of national economies. During this period, there was a gradual growth of Hungary's dependence – measured in physical terms – on energy imports; within this process, the dependence on the Soviet Union as an energy supplier also increased.

During the 1960s and especially in the 1970s, the infrastructure necessary for the primary energy and electricity imports from the Soviet Union was developed and constructted: the electric energy transmission line system, oil and gas pipelines and the Kalus–Leninváros petroleum product line. During that period, one single project of major importance was implemented with a view to achieving a geographical diversification of the infrastructure: the "Adria" oil pipeline, which had been planned on the basis of the "peace-time" oil prices and with regard to dynamically growing demand. This pipeline was left unused for years.

The reaction of the Hungarian economy to the 1973 price explosion came relatively late: the revaluation of energy as a production factor began quite late, on impulses which had already become considerably softened. The second wave of price increases reached Hungarian enterprises relatively faster, and the growth of overall energy consumption

Table 8

Soviet share in Hungarian energy imports and consumption, on the basis of physical units of measurement (1971–1985)

Denomination	Share of Soviet imports in total			
	imports[a]		consumption	
	1971	1985	1971	1985
Petroleum	90	93	66	75
Gas oil	87	99	11	20
Fuel oil	95	33	8	8
Natural gas	–	100	–	37
Electric energy[b]	n.a.	n.a.	n.a.	n.a.
Coal	17	28	1	4

Source: Computations on the basis of the Statistical Yearbook and Foreign Trade Yearbook of Hungary 1971 and 1985.
Notes:
[a]Import data include imports for domestic use and for reexport as well.
[b]Although Hungary is a regular importer of Soviet electric energy, no public data are available about the conditions of these imports.

slowed down to a considerable extent – yet the energy-intensive production structure of the Hungarian economy remained practically unaffected.

Therefore, on the consumption side, Hungarian dependence on Soviet energy supply continued to grow and the sources were not sufficiently diversified from the infrastructural side – instead, the one-sidedness of infrastructural dependence grew further. No important changes took place in the production pattern which might have enabled, by means of the reduction of per unit energy needs, a moderation of the strategic importance of the primary energy imports. Also, no genuine attempt was made to increase the quantity of goods saleable on Western markets, so that scope could be created for the diversification of imports. Efforts to this latter effect, had there been any, would have certainly been countered by the lower prices of primary energies (in particular the price of oil) on the CMEA market in comparison with the then current world market prices.

For the Soviet Union, primary energy exports (above all crude oil) have become by far the most important source of convertible currency receipts during the last fifteen years. In spite of fast increasing extraction costs and the lower rate of growth of the volumes of crude oil produced, Soviet deliveries to the CMEA countries increased right up until the late 1970s. From the early 1980s on, beginning with the stagnation of crude oil production and then with the slow but later rapid decrease of oil price in the world market, it became more and more difficult for the Soviet Union to preserve her income from crude oil exports, and then to prevent its further decline. A change in her distribution policy between convertible currency and transferable rouble clearing relations seemed not only expedient but necessary as well. The Soviet Union's primary economic interest lay obviously in redirecting trade towards sales against convertible currencies – this being the maximum programme. Thus the way was left open to such "second-best" solutions as a) keeping up the level of the clearing trade, with growth taking place only against convertible currency, and b) a general hardening of the terms of compensation within the clearing. Beyond primary economic interests, however, the Soviet Union is strongly interested in seeing that the economic – and indirectly the political – stability of the small European countries should not be jeopardized.

Although within the bilateral trade it seemed – until the end of 1985 – that the main question concerned the extent of the Soviet Union's losses (see the increasing amount of literature on implicit subventions), there is no question of Hungary having earned some absolute or, in other words, some "net" advantage from this set-up. The damage caused by late reaction to changing relative prices in the world economy arose in the first place from the late introduction of energy-saving measures, wrong investment decisions. Besides, in the case of persistently low oil prices, the Hungarian economy gradually "returns" the price gains of earlier years, owing to the sliding price basis – whereas the costs of the late adaptation are never recovered. The Soviet Union, of course, cannot be made responsible for the late adjustment of the Hungarian economy. It can only be stated here that the price gain realized in one partial field of the bilateral relation – a price loss for the Soviet party also in a partial field – led to both positive and negative consequences of identical magnitude with regard to the Hungarian economy.

From the late 1970s crude oil imports, in the framework of the clearing trade, stagnated. The growth of oil imports was only possible through different convertible currency transactions, or by means of "joint investment". Finally, in 1982, the oil quantity laid down for the clearing trade was reduced.

Hungarian energy imports represent, therefore, a field of Hungarian–Soviet economic relations which is characterized by unsolved problems, and in which under the given circumstances, the further reduction of the one-sided or mutual advantages of the cooperation should be hindered or slowed down.

On the Hungarian side, change can be brought about in no other way than making efforts towards developing new general conditions. An important as well as a realistic objective is that which opts for a radical transformation of the energy-intensive production pattern and improvement of the "dollar-earning capacity" of the export branches. It is a gradual preparation for a situation in which there are shrinking import opportunities from the CMEA and, at the same time, the creation of the conditions for diversification of imports by means of increasing export capacities. The present degree of dependence could decrease considerably from the present level or even larger levels of Soviet primary energy imports if, based on the solid financial position of the country, the diversification of sources of procurement becomes mainly an infrastructural problem.

The role of the engineering industry in exports

As has already been stated, the composition of exports and imports in Hungarian–Soviet trade has become very different during the last fifteen years. The most important group of products in Hungarian exports of manufactured goods is composed of machinery and transport vehicles. Nearly half of the Hungarian exports to the Soviet Union consists of engineering products; 4/10 of total Hungarian machinery exports go to the Soviet Union. In the early 1970s, the value of Hungarian machinery exports to the Soviet Union was less than 1.5 times as great as that of machinery imports from the Soviet Union; in the early 1980s the former was already more than twice as great as the latter.

Hungary plays an important role in Soviet machinery imports. In 1985 her share in Soviet imports of machines, equipment and transport vehicles amounted to 9.8 percent. This share was higher than the combined share of the U.S.A., Japan and the FRG (8.7 percent) – this is remarkable even if viewed from the specific angle of the computations made on the basis of the IBEC dollar rate.*

As a consequence of the rising prices of primary energies, the role of Hungarian machinery exports changed to a certain extent, since the latter were now more a form of compensation for the primary energy imports and not the engineering imports. This is to say that, to an increasing extent, Hungarian foreign trade supplied goods qualified as "soft" under the specific system of values of the CMEA in exchange for imports of goods qualified as "hard".

"Softness" of the engineering exports to the Soviet Union manifests itself, among other things, in the price trends. The slow increase of prices is, of course, relative: it can be interpreted in its relation to the rise in production costs on the one hand, and to the improved performance of the engineering goods on the other. The consequence of this is that in the increasing value of exports, it is increasing volumes that are more important.

As for prices, a peculiar trap situation has developed. The majority of the traditional engineering products are in the declining period of their life-cycle. They have been for many years part of Hungarian exports, and even their prices are traditional and thus difficult to change. The manufacturing enterprises can make their choice: either they continue exporting their goods with the usual performance pattern, which means they grow increasingly out-of-date and "soft", and consequently their prices can hardly be raised; or they modernize their products by means of considerable inputs. In the latter case, the buyers' attitude is not very adaptable: either they insist on the old product, or they accept the product of higher quality (yet are unwilling to recognize this quality in the price reflecting the producer's risen costs). To put it simply: the majority of the products, if exported in unchanged form, lose their relative value; if they are modernized and so exported, increased costs are greatly disproportionate to the possible growth of prices. With a considerable part of the engineering products, the extension of the circle of export items saleable on all markets (CMEA and the convertible currency relations) runs

*Vniesniaia Torgovlia SSR 1985, p. 79.

not only into the well-known obstacle that the products that can be sold in the Soviet Union and in the other CMEA countries are not to be placed on convertible currency markets. It also has a less known obstacle, which is that only a part of the engineering products competitive on the OECD markets can be exported as "hard" goods to the Soviet Union and the other CMEA countries. Thus the bilaterally impenetrable wall separating the two markets makes it impossible for Hungarian industry to benefit from the different nature of the two major markets, i.e. to export to the less demanding Soviet and CMEA markets, while developing the mass production of up-to-date products which could then be introduced on the OECD markets at competitive prices. Conversely, it is not possible for Hungarian industry to support some originally OECD oriented developments by considerable volumes of exports to Soviet and CMEA markets.

Hungarian engineering exports are, indirectly, closely related to foreign trade with Western countries. Many of the semi-finished products, parts, and components used for the machines exported come from Western imports. The dollar import content of export goods (i.e. its percentage) does not represent a real bargaining power, i.e. the "hardness" of the goods is correlated to the dollar import content only in a small percentage of cases. This circumstance also, indirectly, hinders the raising of the technical standards of the machines produced for export to the Soviet Union.

It is also characteristic of engineering exports to the Soviet Union and in general to the CMEA, that most of the goods exported – and imported – are finished products. Innumerable resolutions and a lot of agreements concluded notwithstanding, industrial cooperation remains far below the level which could be certainly achieved in a mutual engineering trade of such volume. The reason for this is that no "fine structure" of bilateral economic relations has developed. In other words, there has been no development of enterprise-level cooperation under the impact of market impulses, with concomitant close technological, financial connections and ownership ties. This situation is the direct consequence, partly, of the fact that in Hungary industrial cooperation is also on a low level within the country: enterprises work with a strategy traditionally concentrated on finished products. On the other hand, the nature of the bilateral negotiations, the subordinate role of the inter-enterprise relations, and the given characteristics of the internal mechanism of the Soviet economy do not work towards the evolvement of industrial cooperation, either.

It seems, in the final account and in the long run, that Hungarian engineering exports are, because of their compensatory role, an indispensable element of Hungarian exports to the Soviet Union. The technical standards of these products are, in most cases, below world standards and, with the present conditions of bilateral trade, there is no incentive to raise the standards by means of considerable additional inputs. Thus it is not a realistic objective to make this sphere of products potentially marketable on the two major markets. It is extremely difficult to find the way out of this trap within a reasonable time. Some progress could be made by means of a structural change oriented towards energy and raw material saving, for this could deflect Hungarian engineering exports to the Soviet Union from their forced path by reducing the import dependence on the Soviet Union.

The role of agricultural exports

Agricultural exports hold an exceptional position within the total of Hungarian exports to the Soviet Union. This is because Hungarian exports in convertible currency trade with the Soviet Union practically contain nothing else beside agricultural products. The surplus realized in convertible currency trade with the Soviet Union had, by the early 1980s, become a balancing factor of outstanding importance in the total Hungarian trade accounted in convertible currency.

Since the mid-1970s, when earlier Hungarian exports accounted within the clearing system were joined by deliveries accounted in convertible currency, the share of agricultural and food industrial products in Hungarian exports to the Soviet Union has grown to between 1/5 and 1/3. Also, the geographical distribution of total Hungarian agricultural exports has changed. Until the mid-1970s the Soviet share had been below 1/5 of the total exports, whereas by the mid-1980s it approached 50 percent. The most characteristic items comprising exports to the Soviet Union are cattle and pigs for slaughter, beef and pork, cereals, tinned vegetable and fruit, slaughtered poultry, and apples. The two major items of the convertible currency trade are meat and grain.

According to the original conception, the convertible currency trade – in which price formation is based on current world market prices – should have been of zero balance. This means that Hungary would have bought mainly crude oil and oil derivatives from the Soviet Union, equivalent to her exports. Slowed-down Hungarian economic growth, and the modest success achieved in reducing the growth of energy consumption, enabled the Hungarian party to import relatively little crude oil and oil derivatives from the Soviet Union beside the quantitites bought within the clearing system. Even that was at a value increasingly below the value of Hungarian grain and meat exports outside the clearing. The resulting convertible currency surplus played a highly important stabilizing role exactly in the years 1982–1984 – most critical from the aspect of preserving Hungary's solvency (this function of it has since diminished). In the short run, therefore, the institution of the convertible currency trade had, on the one side, a trade-creating effect, since it drew such goods into the bilateral trade, the volume of which could not have been increased within the traditional clearing system; on the other side, however, i.e. on the Hungarian side, it also had a trade diverting effect. From the shrinking West European markets, in which Hungarian agricultural exports have had centuries' old traditions, a great part of the exports has been redirected to the Soviet market. The balance of the non-rouble trade with the Soviet Union, within the total Hungarian non-rouble trade, has been filling the role of the "pointer of the balance". However, it is impossible for the Hungarian party to calculate, for how long this trade can be maintained. Economic constraints on the Soviet side have become increasingly important. Contrary to the early 1980s, when convertible currency income from Soviet oil exports achieved their highest point, giving way for convertible currency payments in the case of some important items even in trade with CMEA partners declining oil-related convertible currency income since 1985 clearly have made the Soviet party more chary about imports against convertible currency.

The approximately ten-year old trade accounted in convertible currency has been sufficient to start and to strengthen a few specialization processes in Hungarian agriculture. This covers the extension of large-scale grain production, and increased meat production – primarily of partly processed meat. The Soviet Union presents the only large export target for this trend of specialization, since in the world economy today there is a surplus of grain and meat, and no change in this situation can be foreseen in the immediate future. It seems that the traditionally Western-export-oriented Hungarian agriculture makes a significant part of its output one-market-oriented from the foreign trade aspect, and in such a way that no guarantee exists in the long run to ensure that there will be convertible currency returns from these exports. However, a development strategy oriented to a variety of goods and a variety of markets, and to products which have been processed to a higher degree could gradually diminish the risk arising from the possible ceasing of the convertible currency trade with the Soviet Union. Besides, it is reasonable to maintain this convertible currency trade for as long as possible and as long as it is supported by mutual interests – preferably accompanied by a gradual change in the commodity pattern, in order that the share of unprocessed grain and meat should be lowered, so the share of processed foods marketable elsewhere could be increased. However, even with the commodity pattern as it is, it would be worth loosening up the one-market orientation, and attempting diversification within the given limits in grain and meat exports.

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РЕАЛЬНЫЕ ПРОЦЕССЫ ВЕНГЕРО-СОВЕТСКИХ ЭКОНОМИЧЕСКИХ СВЯЗЕЙ

Ш. РИХТЕР

В советско-венгерских экономических связах — на фоне нерешенных проблем прошлого, а также вновь возникших или обострившихся проблем — заметно сокращение взаимных выгод.

Венгерский импорт в последнее десятилетие обеднел по своему составу и все больше ограничивается энергоносителями. В венгерском экспорте определяющей является доля машиностроительной продукции, однако изделия, которые могут быть реализованы на советском рынке, лишь в небольшой степени конкурентны на мировом рынке.

Венгерские стремления к выравниванию двусторонней торговли привели ко все большим экспортным поставкам, в то время как реальная стоимость импорта не повышалась. В сложившейся в СЭВ специфической системе оценки преимущества,измеряемые противопоставлением твердых и мягких товаров, сместились в сторону венгерского партнера, в то же время — это видно, если выйти из данной системы оценки — производство направленного в СССР весьма импортоемкого венгерского товарного фогда подвергает венгерскую экономику тяжелому испытанию, причем стимулы, даваемые советским рынком, не вызывают структурных изменений, которые могли бы привести к модернизации экономики в целом, более того вместо этого стимулировали развитие даже в перспективе неконкурентоспособных на мировом рынке областей.

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THE MECHANISM OF HUNGARIAN–SOVIET ECONOMIC RELATIONS

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The institutional system and mechanism of the Hungarian–Soviet economic relations have essentially been unchanged for several decades. The approach confronting with each other groups of commodities, forcing partial and global equilibrium continues to be in force. A modern system of cooperation in manufacturing has not come about, the improvement of the quality of products traded is hindered by several factors to be traced back to the mechanism. Efforts at mitigating the tensions have remained unsuccessful. As regards the Hungarian domestic regulation of the bilateral relations, no satisfactory answer could as yet be found to the challenges deriving from the different economic management systems of the two countries, and from the system of accounting based on the breaking down of plans.

The organizational system

It naturally follows from the logic of foreign trade based on the quota system that relations are formed on the macrolevel. Foreign trade is still primarily shaped by planning boards (offices) and ministries of foreign trade. This form of cooperation, now justly called 'traditional', has undergone a number of changes in the course of time, yet its fundamental characteristics have remained.

The three supporting pillars of the traditional cooperation are, in consecutive order: a macrolevel collation of plans (5–8 years prior to realization of trade), the system of the five-year records and yearly trade records. These are sufficient for the organization of trade as long as no large masses of new products emerge in the course of development and there is no need for cooperation down to the level of specific components. Such changes did occur in Hungarian–Soviet relations in the early 1960s. It is due to this development that certain efforts were made to insert new organizational units into the chain of cooperation. Thus the sectoral standing committees were formed and these brought about a regular organizational connection between the industrial branch ministries of the two

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We could make use of only scarce published data. Most publications on the topic cannot be used for economic analysis. The ample and high quality CMEA research in Hungary avoids going into the details of bilateral relations, for authors tend to write on Hungary's CMEA relations, instead. This explains why the reader will find a bibliography of the most important sources on Hungary's CMEA relations, Hungarian–Soviet relations included, without exact references in the text.

countries. In the course of the 1960s, foreign trade began to be shaped also on the enterprise level, through agreements made within the country.

All these changes led, however, to the possibility of more intensive cooperation *only* in the case of feedback to the traditional macrolevel decision-making system. With the standing committees, this was not the case. Therefore, the cooperation and specialization proposals made on the branch level rarely came to be realized.

The emergence of the enterprise level in the course of agreements made within the country in fact reflected the circumstance that, as time progressed, an increasing amount of the information wanted for decision-making was in the hands of enterprises. However, this chain-link did not become an organic and legally regulated part of the conciliation mechanism. Such a situation presents a problem especially if there is a clash of interests on the micro- and macrolevel.

The direct international relations of enterprises have only recently gained in importance – mainly due to Soviet initiatives. Earlier, sporadic attempts expressly call attention to the fact that the interest relations of enterprises (their dependence on the macrolevel) hindered their efforts to become independent initiators of forms of international cooperation.

System of bilateral quotas – the basic form of foreign trade

The exchange of goods between the Hungarian and the Soviet economies has, from the very beginning, been within the system of bilateral quotas. In the now more than thirty-year history of the CMEA, the changes which have occurred concern situations in which the quantitative compensation within certain groups of products has sometimes been more emphasized and specified in more detail, and sometimes it has been more global within the sphere of manufacturing industries. However, no such change has taken place within the system of cooperation as would challenge the predominance of a basically quantitative quota system.

This great stability is due to the fact that this is the adequate form of external relations of the domestic system of management and control for the Soviet economy, which plays the dominant role in the bilateral relations. Further, export and import interests can also be represented within this system.

For the Hungarian economy, the quota system has been of an ambiguous influence. In a sytem of economic and control management based on directive plans no other type of foreign trade can in practice be well-operated. The logic of the new economic mechanism introduced in 1968 ran, however, contrary to the logic of the quota system. This is because foreign trade retained its physical nature and continued to be organized on the macrolevel, while Hungarian enterprises were granted independence and expected to make profit on the basis of their activity.

The long survival of the quota system has largely been due to the fact that the product pattern of Hungarian–Soviet foreign trade has basically been unchanged and mutual interests have been attached to this lack of change – right up to the eighties. About two-thirds of Soviet exports were composed of materials, while the same volume of Hungarian exports consisted of finished products, within which the volume of machinery was predominant.

The established Hungarian capacities were adjusted in their scales to this product pattern of foreign trade. As a result of Soviet raw material supplying capacities and Soviet demand for finished products – both believed to be limitless – a circle of large enterprises processing raw materials for the chemical industry and metallurgy based its activities on Soviet imports, and another circle of large engineering enterprises specialized in producing for Soviet exports. This distribution of capacities made the Hungarian economy interested in maintaining the quota system both on the macro- and the microlevels, even after the 1968 reform. It was appropriate as long as the established product patterns and terms of trade remained unchanged. This unchanged character was also due to the fact that this essentially alien external logic could relatively easily be adjusted to the logic of the reform mechanism. The most important reason for it was that, as it followed from the established capacities, enterprises were still interested in fulfilling the targets prescribed on the macrolevel, their increased independence notwithstanding.

Therefore, the quota system, based on a rigid compensation of groups of products, could survive unchanged for several decades. This was because, on the one hand, it was the adequate counterpart of the directive management of Soviet domestic economy and on the other, the demand of the Soviet market and its richness in raw materials had firmly and for a long time established the product pattern and relative values of trade.

It follows that the specialization of the Hungarian economy on the Soviet market took place under stable circumstances provided by the quota system, i.e. in great security. This implies that not only investment allocation was based on this security offered by the framework of foreign trade but, to a considerable extent, the entire planning system itself. For the latter, namely, foreign trade relations with the Soviet Union played a determining role regarding inputs as well as outputs.

The quota system based on compensation by groups of products and on macrolevel decisions raises several problems in respect of manufactured goods. Three negative features require a special mention.

It is one of the necessary consequences of the domestic system of management and control based on directive plans, that the prices of products are inapt for the expression of actual costs. In foreign trade, therefore, these prices cannot be taken as a basis. The prices determining the terms of trade are to be derived from things happening outside the CMEA. In the Bucharest Price Principle, world market prices cleared of market fluctuations were indicated as applicable in mutual trade. The more processed a product, the more difficult it is to find such a world market price. Therefore, while the prices for Soviet exports to Hungary were easily stated relying on stock exchange quotations, the prices of finished products could less easily be found. The uncertainty was made worse by the fact that the overwhelming majority of Hungarian machinery exported to the Soviet Union were not sold outside the CMEA market, so that these products had no real world market price at all. Depending on the economic situation of the Soviet partner (for example, richness or scarcity of raw material), this may equally lead to improving or deteriorating terms of trade, independent of the real demand for, and quality of, the product.

After World War Two, a more intensive division of labour in the world economy and the formation of regional economic integration led to a high degree of specialization in areas within the manufacturing industry – in other words, to a large number of cooperative ventures. Such a development did not take place in any of the bilateral trade relations of the CMEA. This *lack of cooperation* prevented the CMEA from making use of the advantage of profitability offered by economic cooperation on international level. This same particularity suppressed specializations which might have widened the range of selection. As a result of the macrolevel and physical exchange of goods, it was not only the manufacturing of parts which was not specialized. For the supply of parts wanted for servicing was also omitted. The rigid compensation between groups of products also introduced a permanence into the trade of finished goods. This flattened the life-curve of the exported manufactured goods. All this led to a continuous deterioration of quality.

The quota system links the sales and purchase of goods. Another consequence of this is that trade can only be effectuated by the foreign trading organs isolated from the producer, since on the producer's level sales and purchase are not connected. Therefore, no contact could be established between seller and buyer. In raw material trade, this presents no special problem. As for manufactured goods, however, the fundamental motivating factor of further development is the consumers' demand. The Hungarian exporter was, in the majority of cases, not at all acquainted with it. This is to say that, while the capacity of Hungarian engineering enterprises has from the beginning been based on factors related to the Soviet market, the Hungarian producer was not in a position to acquire information on the actual special requirements of the Soviet consumer enterprise. Thus the domestic mechanism based on plan directives and the foreign trade system based on quotas excluded possible contacts between enterprises in general, whether relations aiming at the division of labour among producers, or relations between producers and consumers were involved.

The logic of the quota system thus has led to the isolation of the two countries having foreign trade relations with one another. Because of this isolation, the exporter ot manufactured goods was not under control of the consumer, but – according to the logic of compensation between groups of products – the basis of evaluation was the kind and price of the goods delivered in compensation. This kind of trade is in every way inapt for measuring quality differences. Thus Hungarian exports of manufactured goods to the Soviet Union have developed without market impulses. As a result, the standard of Hungarian finished products has remained below world standards. The finished products, of a quality increasingly below world market standards, have engendered a weak bargaining position in the mutual trade. In the bilateral trade, manufactured goods constitute the sphere of "soft goods", and raw materials that of "hard goods". The trade based on rigid quotas entails, therefore, a grave consequence: the low and deteriorating quality of manufactured goods.

There is yet another particularity of the quota system, mentioned before but needing further explanation, and this also causes quality problems. Within the framework of compensation between groups of products, foreign trade organs practically trade in the entire range of export goods of the country. The higher the number of the articles involved and the greater the total value of the goods exchanged, the more complicated and difficult the compensation between groups of products becomes. Therefore, once an interrelated system of exchangeable goods has been formed, it is preferably not changed. This particularity, a practical simplification from the aspect of planning the exchange, finally works towards conservation of the existing product pattern. Therefore, while mutual trade had been dynamically growing through long decades right up to the mid-1980s, the share of traditional products had been increasing in it. This did not only work against modernization of the products, but it also made shortage permanent. (For example, the efforts, made over the decades, to eliminate shortages of certain parts have been totally in vain so far.)

The physical exchange of goods organized on the macrolevel thus works expressly against the development of high-quality finished products. For Hungary, having concentrated its efforts on exports of manufactured goods – and within this sphere primarily of machines – this particularity holds out the prospect of a serious loss of advantage in the long run. As long as the model of a division of labour based on exchange of raw materials and finished products had worked smoothly, Hungarian–Soviet trade had a stimulating effect on the Hungarian economy. The planning agencies could base the national economic plans on secure and clearly foreseeable perspectives; enterprises functioned under stable conditions of purchase and sales. Thus the problem concerning the quality of finished goods did not come to light within this system. In the given system of interest relations, quality problems found no representation until they emerged in the deteriorating terms of trade.

Attempts at improving foreign trade, based on the quota system

Although shortage phenomena have become permanent, and quality problems in bilateral trade have not led to bringing about mechanisms to solve these problems, efforts have been made in the CMEA, ever since the 1960s, to change cooperation which is unable to go beyond a macrolevel bilateral exchange of finished goods.

Deserving special mention are the efforts to draw the greatest possible number of experts standing on lower grades of the economic hierarchy into the cooperation process, as well as the measures which are intended to establish a common financial system, and also attempts at bringing about direct cooperation between enterprises.

No matter how dynamically mutual trade grows within the quota system, national economic processes remain isolated and, naturally, the experts active in the various fields do not come into contact, either. After the initial years of fast industrialization following World War II, a situation developed in which parallel manufacturing processes and parallel shortages came about, even though the economy was operating within the bilateral relations. This situation first became clear in the context of Soviet foreign trade. The Soviet Union was the biggest buyer of the finished industrial goods of the small CMEA countries. Therefore, in exchange relations, this problem emerged primarily with the Soviet party, but sporadically also with the small countries. Consequently, attempts began to be made at solving the problem.

The attempts were mainly directed at establishing contacts between the heads of industrial branches working alongside the central planning agencies and the foreign trade apparatus. This eventually led to the formation of independent branch committees.

The standing branch committees were organized on multilateral basis. They have advisory functions in respect of specialization, cooperation, and the research and development of new products, etc. Their proposals are – theoretically – to be integrated into the plan coordination and thus also into foreign trade. However, while this system – having made branch leaders' meetings regular – is multilateral, all essential decisions on trade have remained bilateral. No mechanism was created to connect the two different systems. Eventually this led to a situation in which the system of bilateral quotas remained practically unaffected by the multilateral branch proposals. Thus the standing branch committees could achieve nothing positive in their efforts to eliminate shortages and to raise the number of actual specializations and cooperations.

Although it can be said that the regular encounters of technical specialists taking part in economic management were significant from the aspect of gaining important pieces of mutual information, the standing committees cannot be considered as efficient from the aspect of solving the problems.

In the 1960s, a number of changes were made with a view to establishing a common financial system. The two common banks of the CMEA (the International Investment Bank and the International Bank for Economic Cooperation), and the common currency of the CMEA – the transferable rouble – are particularly important in connection with these changes.

The common currency and common banks were intended to enable movement away from the rigid bilateral trade, and were also meant to activate monetary functions in mutual relations (for example, credit granting in the common currency, using assets and liabilities to settle accounts in other relations (countries), etc.). There is no doubt about the rationality and necessity of these changes.

The practical experience of the years following the changes in the financial system made it clear that the establishment of common banks and a transferable currency were not leading to a transformation of the bilateral quota system. A process in exactly the opposite direction began to emerge. The activities of the banks became formal, the transferable rouble became non-transferable, and the bilateral quota system has remained. This means that although bilateral trade balances are settled on the accounts kept on a multilateral basis by the International Bank for Economic Cooperation – this does not occur in reality. The credits granted in transferable rouble by the International Investment Bank can be spent on purchasing goods only if the member countries assume a special obligation to that effect. In such cases, because of the impossibility of the further circulation of common money, the real creditor is the country supplying against credit in tr. Rbl – and not the Investment Bank.

Due to the actual non-transferability of the currency, the instruments enabling bilateral settlements have become formal, and the quota system has continued as the exclusive form of trade relations.

Although the system of macrolevel decisions on the exchange of goods is an essential feature of a quota system based on compensation between groups of products, the need for the contribution of medium- and microlevels has been evident in the CMEA since the 1960s. In those years, not only standing committees, but also joint organizations working with a permanent staff were established. Within a different framework, a similar task had to be accomplished: this was a form of coordination which departed from the national economic processes – again on the level of branch ministries. The branch organizations for coordination could not effectively assert their functions.

This failure can be traced back to more complicated causes than that suggested by the obstructive mechanism of the bilateral quota system. The functioning of these joint organizations has shown that the specialists representing national interests and intended to promote cooperation, are unable to arrive at decisions expressing a compromise on conflicting interests. Therein is manifest the particularity of directive management which makes the actors involved in the conomic processes executors of central directives, so that their interest and responsibility do not lie in economic success, but in the implementation of directives. Thus the representatives of joint organizations did not aim their activities at economic practicability, but at satisfying central directives. This is a paradoxical situation, since these organizations were needed exactly because a number of economic questions could not and cannot be decided on the macrolevel (in fact, some did not and do not arise there).

In the early 1970s joint organizations, in charge of economic duties and functioning with the participation of enterprises, were established. Their scope included specialization, cooperation, joint development projects, joint action on third markets, etc. These were the international economic unions. Such unions were founded at random and in a small number – similarly to the joint coordination organizations – and their activities also brought little success. These enterprises lacked vision, bore no responsibility for decisions or the failure to make decisions, and did not benefit from correct decisions, i.e. they had no independence. In addition, experience demonstrated that enterprise contribution in itself is not appropriate for solving all problems.

The case of the joint organizations emphatically draws attention to the fact that the creation of international economic integration does not only necessitate fundamental changes in the CMEA cooperation. It also requires the transformation of the national economic management and control system so as to lead to enterprise independence.

However, in the 1970s changes exactly of the opposite direction took place in the national economic control and management systems with the exception of Hungary. Thus it is easy to understand why the reform of the CMEA cooperation could not progress during the last decade, even though the Comprehensive Programme approved in 1971 contained a detailed programme for the development of commodity and financial relations within the scope of CMEA cooperation.

Although the Comprehensive Programme suggested the development of financial instruments, a process of exactly the opposite tendency took its course in the process of CMEA cooperation. Rigid quantitative quotas did not simply survive, but even gained in importance: compensation between groups of products covered more goods now than before.

In other words, during the 1970s the directive tendency grew stronger in the CMEA cooperation process as well as in the different national economies. This was the outer environment which confronted the reform of the economic mechanism in Hungary. In the course of the development of the reform, although there were several stoppages, the objective of enterprise independence remained – at least on the level of the basic principles declared. From the international aspect, the ground for this was, on the one hand, that the joining of Hungarian enterprises into the process of CMEA cooperation created no special problem, as has been mentioned above. On the other hand, fundamental changes took place in the CMEA in the late 1970s, creating new and more difficult conditions for all countries, independent of the mechanisms operating within each country.

It can therefore be stated that the scarcity of Soviet raw materials and the drastic changes in the world economic environment comprised the motivation behind the prevailing economic processes, rather than the mechanism problems related to manufacturing industry and its quality.

The same problems appeared again in the late 1980s. However, there has been the essential difference this time that problems of control and management have also developed in the Soviet domestic economy, and the domestic economic situations of the CMEA countries have also become more difficult.

During the last decade, the survival of the rigid quota system in conformity with the directive nature of domestic economic control and management meant that this system also determined the prospects of specialization and cooperation.

Specialization and cooperation have been established in a small number, and even these were organized by the central economic management. Therefore, in the CMEA not many cooperation agreements are initiated on the enterprise level; contrary to enterprise level cooperations characterising regional integrations in the West.

The specialization and cooperation that have been created owing to their special importance (for example, nuclear energy specialization) came into existence because the economic management gave them priority. This special priority not only implies that the exchange of products in the given line was assinged a particular role within the quota system. Also, the specialized manufacture was handled with particular care within the domestic economic processes. Priority necessarily implies a low number of cases. (Many priority cases would amount to no priority at all.) Such specialization which has not been given priority has essentially remained formal.

In addition to the few multilateral cases of specialization, there are a few significant bilateral instances of specialization (for example, the aluminous earth and aluminium agreement) in the area of Hungarian–Soviet cooperation. From the aspect of the mechanism, these agreements fall within the sphere of special regulations, i.e. priorities which result in individual solutions.

Therefore, it can be seen that in the CMEA the bilateral, macrolevel, and physical nature of the form of cooperation has been the obstacle to the emergence of specialization and cooperation. During the decades of the dynamic growth of trade within the framework of Hungarian–Soviet economic cooperation, it was partly owing to the particularity of this foreign trade, based on the exchange of raw materials, that the lack of specialization and cooperation did not represent a serious obstacle to fast growth. As long as costs, range of selection, and quality were not the fundamental considerations in trade, the lack of those close forms of cooperation did not arise in practice.

Even if Soviet political leaders now judge the Hungarian theory and practice of economic control and management differently, and may regard some of its aspects worth studying (for example, agriculture), there is little hope that this will create an impact which can promote the improvement of quality within the processes of CMEA cooperation. This is not only because the quality standards of Hungarian exports to the Soviet Union are not always a credit to the Hungarian economic control and management, but also because, with "soft articles" having a significant weight in Hungarian exports, a "radical" reform might entail losses even for the Hungarian party.

The question is: what are the chances that such changes will take place in the remaining part of the 1980s as would provide for or rather, force out gradual and continuous modernization?

As regards further development, two forms, which developed earlier in Hungarian–Soviet economic cooperation, must be underlined: joint investment and the segment of trade accounted in dollars.

As has been mentioned, the "joint investment" is a special form of credit, granted by the importer to the exporter for the latter's investment into raw material production. The special character follows from the terms and conditions. In the course of time, the contents of the joint investment have changed. Finally, only that part of the joint investment which is in convertible currency has become real credit. The other part is own exports, which entails raw material supply from future capacities, up to the value of the goods delivered. This is compensated in the given year by exports of average "hardness" – thus it represents no credit.

The construction of joint investment finally leads to a change in the terms of trade to the benefit of the raw material supplier.

The Soviet economy, struggling with a shortage of resources, is basically interested in obtaining contributions through joint investment. However, all the raw material importers, Hungary among them, struggle with similar shortages. Thus the investment contribution involves conflicting interests.

From the aspect of the problems of the economic mechanism, it is a specially important issue to see which way the conflicting interests will be resolved in the joint investment. If the approach that wants to secure raw material supply wins and the traditional way of surplus production remains, the raw material sector will be given priority in the allocation of investments – this will then work toward directive management and rigid quotas. If priority is given to the development of the manufacturing industry and structural change is aimed at economy with raw materials, the amount of joint investment will be low, and the development of commodity and money relations will receive considerable stimulus in the domestic economy as well as in mutual trade.

The existence of dollar accounts in the bilateral relations allows both the separation of sales and purchases, and their rigid coupling. It could enable acceleration of the modernization of the manufacturing industry, and favour goods earlier qualified as hard.

In Hungarian–Soviet trade, the segment accounted in dollars grew in significance in the early 1980s. It was growing fast, and reached a high level. However, this is not to say that it worked towards "hardening" the products of the manufacturing industry. The reason for this lies in the established product pattern. Material products are exchanged and, even now, a considerable part of Hungarian export sales are settled in cash – in dollars – by the Soviet party.

The dollar trade was not introduced as a part of any reform of the CMEA – i.e. upon theoretical considerations – for it was the outcome of real needs and real possibilities.

As a genuine solution, it represents a new method in the mutual relations. As a special field within the mutual trade of "hard" goods of a material nature, it fits in with the logic of the quota system, which consists of the bartering of products.

Aside from the practical advantages of a given time, this form is to be judged, in the final account, by the fact that no manufactured goods are involved in the dollar sphere. This fact calls to attention the point that it would be worth examining the question of dollar accounts in terms of the economic mechanism.

The dollar is real money, and it has all the functions of a currency. As such, it could contribute to forcing out demand-oriented supply in the manufacturing industry as well. Namely, dollar would only be paid for goods of "Western" hardness. This kind of buyer's attitude would be enough to force out modernization of the manufactured goods.

The fact that no manufactured goods entered this sphere even at the time of the fast growing trade which was settled by actual dollar payments, also calls attention to the uncertainty regarding the quality of these products. This remains a fact even if the segment of trade accounted in dollars was originally earmarked for the delivery of wheat and meat on the Hungarian side, and of oil on the Soviet side.

Summing up, the trade that has been accounted in dollars must be considered as fitting in the logic of the quota system from the aspect of the economic mechanism.

The Hungarian economic control and management system, and the Hungarian–Soviet economic cooperation

The 1968 Hungarian reform championing enterprise independence was based on the (albeit undeclared) assumption that in the CMEA countries, and in their mutual relations, a fast development of commodity and money relations would soon begin.

It has been mentioned above that exactly the opposite development took place in the 1970s. The Hungarian domestic mechanism, and the mechanism of the Soviet economic relation – an important determinant for Hungary – were of a contrary nature. This qualitative difference posed a problem in the daily practice of trade.

It turned out in practice that, as long as Hungarian–Soviet trade was carried on at unchanged prices and with an unchanged product pattern, this determinant foreign trade relation could be regulated without involving major conflicts for the enterprises.

Regulation in the spirit of the reform consisted, first of all, of a situation in which the exporting enterprise's income was earned in conformity with the actual selling price, and the forint price of imports was also stated on the basis of the actual trf. Rbl price. Of course the forint amounts, formed on the basis of the rate of exchange, had to be modified by means of various financial bridges. However, this was not of such extent that it wiped out the link between the external and the domestic price. Financial bridges were necessary, because in the trade based on quotas the real value of the product is manifest not only in its price, but also in the kind of product supplied as a counter-item.

Financial bridges were also needed to maintain the relative profitability of the sales on different markets, centrally judged as correct. Namely, it soon became clear in the course of the early years that it was incomparably more difficult for enterprises to export to Western markets than to the Soviet Union. This also had to be made manifest in the relative profitability of sales.

Maintenance of the established system did not hurt the interests of either party, and the new Hungarian domestic financial regulation did not interfere with the functioning of the traditional trade, which was based on quotas.

If, however, the situation is judged from the aspect of how much independence enterprises received in this relation and, of key importance, how they were able to adjust themselves to market conditions with as much advantage as possible, it is not so perfectly free of problems. This is due to the fact that the Soviet market remained as secluded as it had been before, and the product pattern was based on macrolevel decisions and quotas which linked up groups of products just as before. Thus demand could not motivate enterprise interests. Instead, exporters' interests lay in capacity utilization and profitability in terms of forint, and importers' interests in smooth material and energy supply.

Therefore, as opposed to Western trade in which enterprises had to face the rules of the world market, in the Soviet trade relation enterprises received no impulse from the demand side. However, the linking up of the forint and the trf. Rbl price had at least the advantage that it showed the exporting enterprises which articles were unprofitable in exports. Within this sphere, enterprise profit incentive came to be asserted, and efforts were made to reduce or even stop the exports (and production) of the articles in question. It must be stressed that the volume concerned was not such as would demand fundamental changes in the enterprises.

This was the period in which the volume of Western imports was increasingly liberalized. The quality of manufactured products considerably improved owing to the Western imports incorporated. Some of these improved-quality products found their way into exports to the Soviet Union. The greater part of these products, however, was not introduced into the bilateral trade. The enterprises found that, owing to the quota trade, their Soviet partners were not quality-oriented, i.e. improved quality did not entail a higher selling price. Therefore, the enterprises became interested in selling these products on the domestic market and, if it was possible, in exporting them to the Western markets. Owing to the exposure to different buyers' attitudes, the three markets (socialist, domestic, Western) became clearly divided for the enterprises, despite the similar regulation which applied to each market sphere.

The division of enterprise activities, according to Western and CMEA (within the latter, primarily the Soviet) relations, took place despite the fact that in that period, expectations toward the different treatment of the two major markets had not yet been formulated on the macrolevel.

The different treatment of the two major markets in enterprise practice is congruent with that particularity of the quota system which acts towards conservation of the product pattern, and tends to promote its deviation from the system of Western markets based on the interaction of demand and supply. The logic of the quota system consists in compensation of trade by groups of products. The greater the trade turnover and the greater the number of articles included, the more difficult – even absurd – it is to put into reality this linkage of goods. It is obvious, therefore, that in this system the apparatuses engaged in effectuating foreign trade, and interested in technical simplification, are in the same way interested in maintaining the traditional product pattern.

In the late 1970s the situation fundamentally changed in the Western as well as in the Soviet relation. This raised doubts as to the established system of the Hungarian domestic regulation of foreign economic relations. Imports from the Soviet Union gradually became scarce with regard to raw materials. On the world market, the earlier system of values underwent a fundamental change as a consequence of the two oil price explosions. Hungary's Soviet relations were also directly affected by this change. For Hungary, this situation set off disadvantageous changes in both major foreign markets.

In Hungary's trade with the Soviet Union, after the 1976 introduction of the system of yearly price changes, the terms of trade deteriorated over the next decade, while the procurement of raw materials became increasingly uncertain. In the trade with Western partners, serious payment difficulties arose and the Hungarian economy could only ease these at the cost of a considerable reduction of imports.

During this time, thorough changes began in the financial regulation of enterprises. The most significant change in Soviet economic relations was the abolition of the link between forint and tr. Rbl prices in exports as well as imports. The enterprises' returns from exports in forint became the average profit of domestic and Western sales. The forint price of imported raw materials came up to a level which conformed to the world market price. These changes were meant to express the fact that raw materials and energy had become scarce import goods. On the basis of the norms and systems of values formed as a result of earlier development, this necessarily became a source of tension between the central economic management and enterprises. The tension was caused by the fact that, in accordance with the deteriorating terms of trade, enterprises' incomes from Soviet exports had to be reduced – export restriction was even necessary in a few cases. Both kinds of measures put the enterprises into a difficult situation, without their directly experiencing the changes that had taken place on the foreign market (although these had led to that aggravated situation in the first place).

The conditions of enterprise economy were growing more difficult not only because of the changes in the Soviet economic relation, but also because of those in Western trade. Enterprises were most affected by the much narrower importing possibilities. Smooth production and modernization ran into increasingly difficult conditions. The consequence of this was the reduction of exporting capacities to the West.

Financial regulation mainly conformed to the equilibrium requirements of macroeconomy. Meanwhile the conditions of adjustment of enterprises to the changed foreign market situation were not created. The non-market characteristics of the quota system showed their really harmful nature in this situation. The fact that the Hungarian terms of trade were continuously deteriorating as a consequence of the rising prices of raw materials ought to have led to a change in the export pattern which would have improved the positions of Hungary as a finished goods exporter. Instead, the structure-conserving effect of the quota system asserted itself. Enterprises were unable to adjust themselves to the changed circumstances through the improvement of quality and the reduction of costs, i.e. through economic rationality.

This situation, which conserved negative processes, was manifest in administrative elements – alien to the reform spirit – which proliferated in the regulation of enterprises in respect of foreign trade with the Soviet Union.

In the late 1980s, there have been changes in the outer environment of the Hungarian economy from several aspects. This is mainly due to the fact that the world economy has overcome the effects of the two oil price explosions. Globally, world trade is now in the situation which has followed a successful adjustment to changed circumstances. In Hungary's Soviet relations, this involves two important facts. First, the deterioration of the terms of trade that has been going on for a decade is rapidly slowing down, and second, Soviet economic difficulties are growing because of the serious loss of foreign exchange revenue as a consequence of the fall in oil prices.

The latter change has an unfavourable impact on Hungarian economy as well. Scarcity of raw materials in Hungarian imports from the Soviet Union will continue to be characteristic. This leads to conflicting interests in the quota system, which hinders the regulation of this predominant foreign trade relation in compliance with the domestic mechanism.

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МЕХАНИЗМ ВЕНГЕРО-СОВЕТСКИХ ЭКОНОМИЧЕСКИХ СВЯЗЕЙ

М. РАЦ

Механизм управления венгеро-советскими экономическими связями совпадает с механизмом СЭВ, основанному на жестких контингентах. Это отвечает и тому характеру внутренней хозяйственной деятельности на основе натуральных плановых заданий, который до последних дней

отличал советскую экономику. Принципы проведенной в 1968 г. в Венгрии хозяйственной реформы и натуральный характер внешней торговли находятся в противоречии.

До середины 1970-х гг. эта проблема на практике не стояла так остро для венгерской хозяйственной системы. Причина этого в весьма стабильных традиционной структуре и пропорциях товарного обмена до середины 1970-х годов. В условиях такой стабильности и в отношении внешней торговли с СССР можно было наладить регулирование, которое соответствовало логике венгерского механизма. То есть между внешними и внутренними ценами импорта, а также доходами предприятия от экспорта в форинтах можно было достигнуть связь характера валютного курса. Однако это регулирование могло действовать лишь до тех пор, пока не произошло существенных изменений обменных пропорций. Это изменение началось вслед за резким повышением цен на нефть и привело в венгерской экономике к административным мерам в отношении торговли с СССР. В результате торговля венгерских предприятий с социалистическими странами была изолирована от внешних связей. Поэтому каждое изменение воспринималось как меры венгерских ведомств. Это вызвало внутреннее напряжение.

При существующих условиях выработка соответствующего духу реформы и структурным интересам венгерской экономики регулирования является весьма трудной задачей. Можно предположить, что регулирование должно подчинить венгерскую обрабатывающую промышленность требованиям международной конкурентоспособности. Это требует не только пересмотра венгеро-советской торговли, но и разработки нового комплексного плана модернизации.

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"CYCLES" IN HUNGARY'S TRADE WITH THE DEVELOPED WESTERN COUNTRIES*

J. SUBA-VARGA

In Hungary's trade with the market economies such regularities could be found between 1950–1981 that cannot be deduced from the actual state of the investment cycle. The article points out that these particular regularities constitute a "typical trade cycle" and analyses the main motive powers to which the periodical movements of trade can be traced back from the mid-sixties to the mid-seventies.

Some phenomena of the trade between Hungary and the developed Western countries indicate that the Hungarian economy is inclined to have a deficit in this trade. Such phenomena were the statistically traceable regularities which appeared in Hungary's trade with the developed Western countries in the late fifties, but took their "purest" form in the mid-fifties and lasted till the mid-seventies. These regularities derived from the direct interferences of the central leadership with the foreign trade processes as a reaction to the long-term tensions showing in the balance of this Western trade. These interferences then produced a cycle in this sphere of trade, which became separated from the investment cycle as well as from the periodical fluctuations observable in the trade with the socialist countries. The regularities found in the trade with the developed Western countries were quite particular – namely, they were not to be found in trade with the socialist countries. As a consequence, they produced a type of cycle in Hungary's trade with the developed Western countries which can be described as having an independent mechanism of movement.

The mechanisms of movement of the turnover cycle in the trade with developed Western countries

Before describing the mechanism of movement, I am going to review the particular regularities of which a typical cycle is "composed" in this market.

*This article is based on a part of the same larger study [1] on which the authoress also relied for the article published in *Acta Oeconomica,* Vol. 36. Nos 3–4. For their valuable critical comments thanks are due to Tamás *Bauer*, András *Bródy*, Tibor *Erdős*, János *Gács*, András *Köves*, Mária *Lackó*, Kamilla *Lányi*, András *Nagy*, András *Simonovits*, Károly Attila *Soós*, and Iván *Szegvári*. The authoress alone is responsible for the remaining mistakes.

a) Periodical decline of imports

It was characteristic in the trade with the West that at the lowest points of the import cycles* not only the growth rate of trade diminished, but generally the volume of trade also fell in absolute terms relative to the preceding year.

The periodicity of import reductions is easily observable in this market. This is what renders the phenomenon particular. There was also a periodic decline in imports from the socialist countries, occurring with the same frequency as the decline in imports from the West. However, the decline of imports from socialist countries, in absolute terms, was concentrated in the late seventies – that is, in this respect no periodicity can be distinguished.

b) Relationship between the cycles in the balance of trade and in exports

This relationship manifested itself in a regularity which may be described as a form of lagging interrelation between the levels of indicators constituting the two time series. The interrelation is the following one: whenever the relative balance (export as a percentage of import) was low, relative to the level of the preceding years, the dynamics of export rose over the following two years; and if this indicator was relatively high, the dynamics of export declined over the following two years. [3] Beyond that, a simultaneous and equally close statistical relationship may be observed between the changes of the balance position of this market and the changes in the growth rate of export.

In Hungary's trade with the developed Western countries it occurred with such a high frequency (28 times out of 31 in the examined period) that an acceleration of exports was accompanied by an improvement of the balance, and a decleration by its deterioration.**

The interrelations between the balance and exports allow us to conclude that there is a "two-way" link. In addition to the fact that the balance strongly influenced the dynamics of exports at any time, a reversed relationship also existed; namely, a growing or diminishing dynamics of exports was, in general, an important factor in the short-term equilibrium situation.

*For the investigation of export and import cycles the indicator of annual growth rate has been used. Later I shall frequently use the terms "acceleration" and "deceleration" – these merely refer to the quantitative changes thus shown in statistics. For the exact sources of the data in the text and the tables see [2]; they are all publications of the Central Statistical Office of Hungary.

**It is not a particularly evident interrelation that a dynamic growth of exports (and/or a declining dynamics of imports) should be accompanied by an improving balance, nor that a decelerating growth of exports (and/or and accelerating growth of imports) should entail a negative balance. For example, in Hungary it was only in two-thirds of the examined cases that the imports from and the exports to the socialist countries, and the imports from developed Western countries, "explained" the development of the balance in the above sense in the given year.

c) Relationship between the cycles of the balance and imports

In certain years, well identifiable within a cycle, a close relationship came about between the growth rate of imports and the direction of change in the balance position. These years were the second ones in the improving phase of the balance. (Insofar as such a year existed at all; in other words, there were some cycles when the improvement only lasted for a single year.) The regularity is that in the second year of the improving phase of the balance of trade with the West the growth rate of imports increased. (See: *Table 1*)

d) The two-year acceleration phase of imports

In the trade with the West it was typical that the acceleration of imports lasted for two years. A two-year acceleration of imports occurred relatively more frequently in the trade with developed Western countries (in 6 cases out of 8) than in that with the socialist countries (5 times out of 9).

*

The mechanism of movement of the turnover cycles in the trade with the development Western countries can be described *in every year* with the characteristics of export and import dynamics. Let us consider how a "typical" turnover cycle "is composed" in the trade on this market.

	Phase of deterioration		Phase of improvement	
	first year	second year (if any)	first year	second year
Exports	decelerating	decelerating	accelerating	accelerating
Imports	accelerating	?	falling	accelerating

The development of such an expressly "typical" cycle can be traced between 1970–1973. This was the sixth such cycle since 1950, the starting year of our investigations.

In 1970 the balance became negative.* The deterioration of the balance occurred in such a way in that year that the growth rate of exports fell from 125.6 percent to 121.6 percent against the preceding year, while that of imports rose from 107.5 percent to 141.8 percent.

*Otherwise, in the period examined (1950–1980) the balance of trade with this market showed a surplus in 1969 only.

For describing the short-term tendencies of the balance the indicator of export/import cover was used.

Table 1

Interdependence between the import cycle and the balance-of-trade cycle in Hungary's trade with the advanced Western countries (imports as percentage of the previous year)

	Year	Balance	Imports
1st cycle	1951	deterioration	86.0
	1952	deterioration	99.0
	1953	deterioration	105.0
	1954	improvement	119.0
	$\boxed{1955}$	improvement	139.0
	1956	improvement	76.0
2nd cycle	1957	deterioration	114.0
	1958	improvement	85.0
3rd cycle	1959	deterioration	125.0
	1960	deterioration	130.0
	1961	deterioration	127.0
	1962	improvement	110.7
	$\boxed{1963}$	improvement	112.4
4th cycle	1964	deterioration	125.4
	1965	improvement	99.4
	$\boxed{1966}$	improvement	111.0
5th cycle	1967	deterioration	97.1
	1968	improvement	100.1
	$\boxed{1969}$	improvement	108.0
6th cycle	1970	deterioration	142.0
	1971	deterioration	90.0
	1972	improvement	109.0
	$\boxed{1973}$	improvement	120.0
7th cycle	1974	deterioration	160.0
	1975	deterioration	110.0
	1976	improvement	98.0
8th cycle	1977	deterioration	118.0
	1978	deterioration	119.0
	1979	improvement	99.0
	$\boxed{1980}$	improvement	102.0
	1981	deterioration	105.0

Years in squares indicate the second years in improvement periods.

The balance continued to deteriorate in 1971: exports only amounted to 73.8 percent of imports against 92.8 percent in the preceding year. The tendencies of the preceding year also continued in exports as regards the dynamics of trade. The deceleration of exports was of such extent that year that this alone would have been sufficient for the deterioration of the balance: not only the growth rate but also the value of exports declined. This can also be seen from the fact that the deterioration occured in spite of a deceleration relative to the preceding year, in the dynamic growth of import. Imports from the developed Western countries exceeded the value of the preceding year by "only" 23.2 percent in terms of the value in 1971, against 41.8 percent in 1970.

The first year of the phase of improvement was 1972, the value of the "coverage" indicator rising to 92.5 percent. The reversal of the tendency of deterioration was "supported" by the development of both the export and the import dynamics. Exports increased in terms of value by 22.9 percent over the preceding year. But the genuinely drastic change could be observed in imports: the value of imports diminished in absolute terms. In terms of value, 2 percent less commodities were imported in 1972 than in 1971.

In 1973, the last year of the cycle, the balance position continued to improve: in that year the country succeeded to export as much as was spent on imports. This could only be attained by further increasing the export dynamics (by 27.5 percent). The balance-improving effect of imports no longer "operated": the value of imports increased by 18 percent relative to the preceding year.

Interpretation of the typical turnover cycle

There are marked signs of the operation of some kind of "mechanism" in the trade of Hungary with its developed Western partners, and this has secured the persistence of periodicity in foreign trade. In the following an attempt will be made at interpreting this mechanism.

From among the driving forces shaping trade, I would stress two: the equilibrium situation (that is, the response of operative control to its development) and the impacts of the investment cycle. Obviously, the growth rates of exports and imports are also influenced by other factors beyond these, e.g. the price and volume impacts of external markets, and other viewpoints are also asserted in the central regulation of foreign trade. Yet I think that in the period examined there existed a mechanism of movement prompting periodical fluctuations, the most important driving forces of which were the two factors mentioned. I do not mean that this is the only possible explanation for the periodical movement: it is a hypothetical one.

In this context, the first push starting the short-term cycle is given by the lifting of investment restrictions. *Figure 1* provides a good illustration of the fact that the easing of investment restrictions immediately shows in accelerating imports. Thus the starting point of our description is the year when imports begin to accelerate. This is when the conditions of increasing deficit are brought about. Therefore, paradoxically, the descrip-

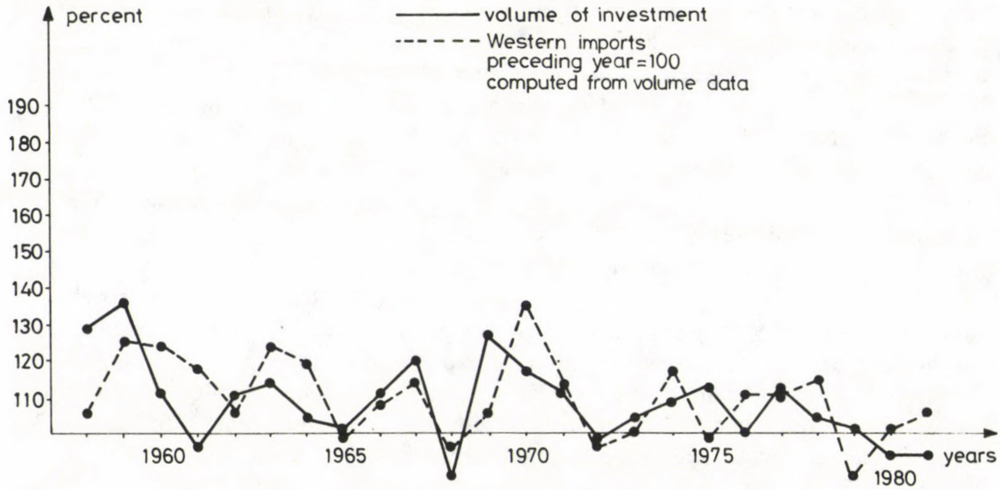

Fig. 1

tion of the process of deterioration is expediently started with the last year of the phase of improvement.*

This year may be considered as a transition from the phase of improvement to that of deterioration. Easing of the investment restrictions leads to a stronger expansion of imports than in the preceding year, while there is still a need to improve the external equilibrium situation.

This is partly shown by the fact that the centre deems the boosting of exports to the West important, and stimulates it with various instruments: exports are thus accelerated. On the other hand, the transitory nature of this year is also reflected in the structural changes of imports. Only the import goods judged most important (i.e. the inputs into production) flow in to an increasing extent. *(Fig. 2)*

With prolonged foreign trade tension, the inclusion of imports into the easing of shortages is not self-explanatory – not even in a shortage economy. Because of the danger of deficit, the satisfaction of import needs does not, in general, seem absolutely justified on the macrolevel – but it is, if at least the emergence or proliferation of shortages in production can be prevented. Let us not forget that the growth rate of production is always an important and preferential viewpoint of the central plan. Under such conditions, from the short-term, cyclically-emerging import needs, it is those serving the inputs of current production that are likely to be the most important ones in the eyes of the central control agencies. It may be assumed that the central leadership is more inclined to

*I will return to a more detailed description of the foreign trade process of this year when reviewing the phase of improvement.

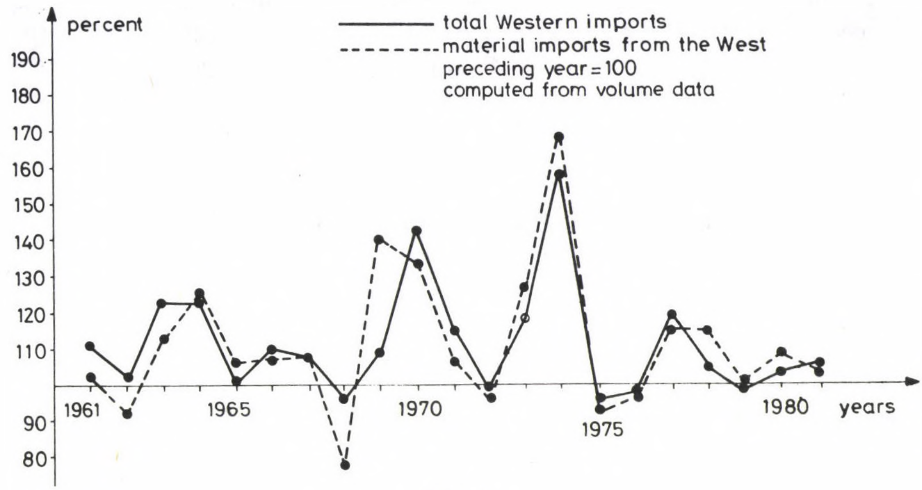

Fig. 2

expand the import of materials* than of other products. One manifestation of this behaviour is that the import of materials is curbed less whenever restriction is the order of the day. In an economy where shortages are more pressing, efforts and stimulation for the fullest possible utilization of capacities are evident. It follows that material supply has always to be secured. In the Hungarian economy, where there is always excess demand – even in production** – not only the demands of firms work very fast towards expanding material imports, but also the demand of the centre increases material imports.***

In this cycle this is manifested in a push given to the acceleration of imports by the dynamic growth of material imports. This can also be seen from the commodity pattern of imports. The ratio of materials is high in imports from the West, thus a dynamic growth of this group of commodities almost automatically entails the acceleration of total Western imports.****

*Here and henceforth, in this context, the notion includes intermediary products as well.

**This is explained – relating not only to production, but to every sphere of the reproduction process – by Zsuzsa *Esze,* in the course of defining a particular notion coined by her: "overheatedness". [4]

***Such behaviour of the central leadership in a socialist economy may also be observed on the basis of results derived from a macroeconomic model for the Czechoslovak economy [5]. In this model, the relationship between economic growth and the trade with developed Western countries was examined by groups of commodities. It was found that, from the groups of commodities, that of materials was the only one the imports of which were not influenced by the actual state of the balance of payments with these countries, nor by the foreign exchange position. In their formulation, in the case of inputs into production, "the foreign exchange constraint was soft."

****According to input–output computations, between 1958–1976 roughly 70–80 percent of imports against dollars were used for production in the Hungarian economy [6] while, between 1959–1971, 67.4 percent of all imports served the current needs of production. This ratio has not diminished since, either.

The distinct role of the material-import-push in the "initiation" of the process of deterioration may also be rendered likely by that well known property of trade with socialist countries which involves trade transactions according to plans, on the basis of quotas. Imports *above* the plan cannot usually be secured immediately from the socialist countries, at the time when the needs emerge. This quantity must and can be satisfied from Western countries. The inflexibility of procurement from socialist countries thus becomes – through the investment cycle – a cyclical element of imports from the West.

With the second year of accelerating Western imports we have "entered", in our description, the first year of the phase of deterioration.

The first year of the phase of determination

In this year imports continue to accelerate and exports slow down.

The fast growth of domestic requirements exerts pressure on *imports* not only in respect of materials, but also with regard to other products – investment goods and consumer articles. The outflowing surplus purchasing power leads to the shaking or upsetting of the planned balance between demand and supply on these markets also. On the macrolevel it may seem – if we set out from the logic of the turnover cycle – that the meeting of surplus demand for imports is not hindered in this year of the cycle by the danger of upsetting external equilibrium. This is supported by two factors: 1. the deficit of the balance diminished continuously in the preceding two years; 2. in the current year pressure towards imports usually diminished as against the preceding year, and the rate of growth of material imports slowed down.

The regular declines in the dynamics of imports from the West coincided in time with the rising dynamics of material imports from the socialist countries. The central leadership generally makes efforts (because of the pressure of a chronic shortage of foreign exchange) to procure the import goods first of all and mainly from the socialist countries. It does this, as before, to "rechannel" the above-the-plan material imports of the preceding year from Western to socialist countries. Even if a reserve material import cannot be "built" into the quotas in the course of interstate negotiations, it could still be achieved in the course of annual discussions.* In these years of the cycle the growth of imports from socialist countries generally did accelerate relative to the preceding year, thus allowing a reduction of the growth rate of material imports from the West.

Such "regulation" of material imports as between Western and socialist markets could be observed in the phases of acceleration of material imports between 1960–1975. The phases of acceleration were characterized by a complementary development of imports from the socialist and the Western countries. Whenever imports from one of the

*As against the practice of the fifties, the mechanism of trade between the CMEA countries became more flexible in the sixties and seventies, in the sense that in the course of annual negotiations there was regularly a possibility to deviate from the quotas laid down in the five-year interstate agreements [7, 8].

Table 2

Regularities in the import of materials, based on value data (preceding year = 100)

Acceleration phases of material imports	from socialist	from Western
	countries	
(1961)	106.1	102.4
1962	113.4	92.2
1963	104.4	113.1
(1965)	102.7	106.4
1966	102.2	107.3
1967	108.4	107.0
(1969)	101.2	140.1
1970	115.3	133.7
1971	117.9	106.7
(1972*)	102.0	92.5
1973*	101.8	114.8
1974*	107.4	117.1

* Computed from value data. The years in parentheses indicate those preceding the phases of acceleration.

markets accelerated, those from the other decelerated (or even declined in absolute terms). (See *Table 2*)

The "calibration" of material imports may be the decisive factor explaining why the acceleration of total imports from the West can be continued. The continuous acceleration "is secured" by the accelerating imports of consumer articles and engineering products. The regular re-channelling of material imports from the West gives the green light to easing import restrictions in the field of the other "residual" groups of commodities as well.*

Those researching into the investment cycle stress the role of the machine and building material imports in generating cycles [9, 10, 11]. This is understandable: owing to their subject these researchers concentrated on those groups of commodities. It is, however, worth noting that whenever imports from the West accelerated, the growth rate of imports of *consumer goods* was usually higher than the average.

Upswing in investment also affects the consumer markets and, through the secondary effects, the intensity of shortage also increases on these markets. True, rising demand

*This kind of "calibration" did not mean that such complementary development of real processes was optimal for the operation of the economy also in respect of the final results. As a matter of fact, the imports from the two markets do not substitute each other, as is also supported by the structural deviations. This is precisely the reason why Western material imports could not be curbed longer than one year if smooth production was to be secured. And this is why an actual re-channelling of material imports could not be realized. The statistically shown complementarity reflected in this case "merely" the central intention.

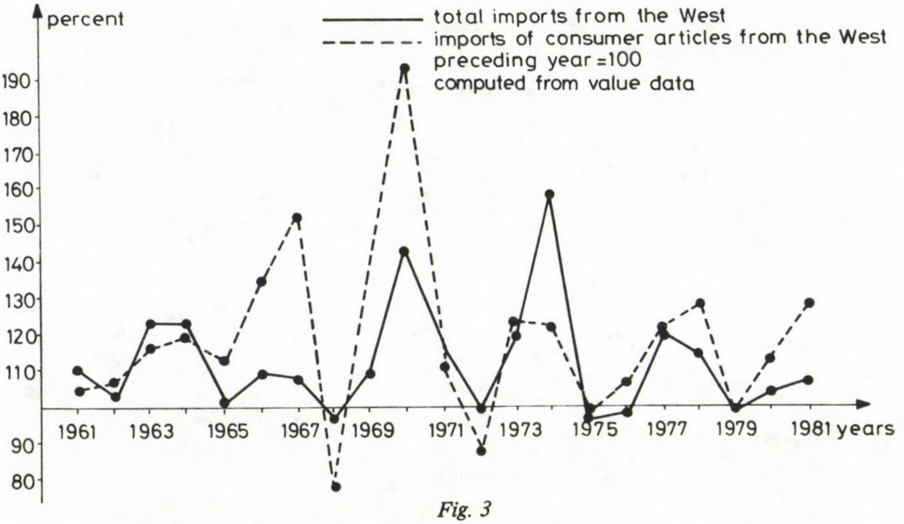

Fig. 3

may be followed by an accelerating growth rate of production – if with a time lag – insofar as the annual plan can provide for accelerated production in the industries turning out consumer goods. But such expansion of supply does not guarantee the surplus incomes paid out in the course of increased investment activity and employment can be actually spent. The adjustment of supply to demand is usually cumbersome and inflexible.* Tension even appears, in the case of these products, in foreign trade. Whether the tensions arising in such cases are eased through imports (if at all), depends on economic policy decisions.

It was an enduring element of living standards policy in Hungary that, whenever the equilibrium between the purchasing power and the available commodities became upset, economic policy tried to restore it by engaging the purchasing power of the population and not by curbing demand. [15]

This may be complemented by the following: the economic policy outlined resulted – among other things – in the operative control agencies trying to resolve the unexpected disturbances in the balance of products not only by stimulating domestic production, but also by increasing the supply of imported products. These additional imports could be procured most rapidly from the Western economies. If the shortages were particularly pressing, the import of consumer goods from the West was increased even if there was an imminent danger of becoming indebted.**

*The scope of these problems was debated in the course of the discussions in *Közgazdasági Szemle* and *Acta Oeconomica* by János *Kornai* [12], Károly A. *Soós* [13], and Judit *Szabó* [14].

**E.g. in 1963–1964 there was a big shortage of food in Hungary. In March, 1964 "food imports. . . were almost double of that in the first two months of 1963. . . . the import of food almost amounted to one half of all imports from the developed Western countries." [16] Imports were then increased in spite of the adverse balance-of-payments situation.

If imports from Western countries are "resorted to" even in the case of an unstable balance of payments, this can happen even more frequently if the external equilibrium does not seem to be menaced. The situation is precisely such in the first year of the phase of deterioration. In such cases one may conclude from the balance of the preceding year, that there will be no equilibrium problems: the balance of trade has been improving continuously for two years. Therefore, in such cases the central leadership not only eases the import restrictions on inputs of the production and investment spheres, but also increases the foreign exchange allocated for the import of consumer goods.

The deceleration of *exports* in the first (and the second) years of the phase of deterioration can be interpreted in the same way as the acceleration of imports of consumer goods: with the routine-like reaction of the centre on the equilibrium situation.*

The fact that the growth rate of exports to the West increased that of imports through two preceding years, evokes a feeling of security with the central leadership and therefore the latter do not force exports.

By forcing exports I mean that the central economic leadership underlines the importance of raising exports and accords it priority within the system of preferences. From the aspect of the actually materializing processes, the important thing is that the actual instruments reflecting the system of preferences were adequately used. Thus, under the mechanism of the directive planning system such operative official measures were taken that aided the quicker regrouping of available commodities for export purposes than had originally been provided for in the plans. After the introduction of the new mechanism, when there was a chance for operative control to influence the distribution of exports by markets with the aid of value categories, exceptions were made to the financial regulatory system (originally intended to be normative) in the interest of a faster growth of exports to the developed Western countries.

The ceasing of forced exports and the missing separate stimulation usually resulted in a diminishing growth rate of exports. It may be assumed that the planning agency usually did not expect it. Originally, for these years too, a higher level of exports had been planned than was actually achieved. Yet this deviation comes about not only because planners do not perceive, at the given moment, what quantity of exports to the West the firms are actually capable of attaining. Another cause of the deviation is that the central leadership is aware – from the experience gained after some time – that the export efforts of firms are generally weak on this market relative to the expectation and this is why it makes "tense" export plans. The centre tries to bring the value of export in line with the planned imports with this kind of planning also, in the spirit of "requirements". This practice involves a situation in which either the extent of the deterioration will be higher than originally planned, or the balance deteriorates instead of the planned improvement or unchanged position. At this point of the cycle there would be a deviation

*Gács–Lackó [17] have pointed out such schematic reaction, depending on the balance position, in Hungarian planning practice. Julia *Zala* [18] interpreted the deceleration of total exports linked to the investment cycle in a similar way, insofar as she found its cause in the routine measures of the centre.

from the plan in respect of the balance position even if "only" the planned imports were realized. This circumstance introduces a relatively bigger uncertainty into the planning of foreign trade processes than that which is usual in other years.

The factor of uncertainty related to the balance is further strengthened by the fact that, in the first year of the deterioration of the balance, the acceleration of imports is in practice usually greater than expected by the planning agency. This is why the balance position might be already *significantly* worse in the first year of the phase of deterioration. In addition, the occurrence of such a possibility seriously influences what will happen in the foreign trade processes in the second year of the phase of deterioration.

The second year of the phase of deterioration

From the years of the turnover cycle it was only the second year of the phase of deterioration that developed in an uncertain way. First of all, it was doubtful whether deterioration would actually occur – in other words, whether the deterioration of the balance would continue for two years. The other uncertainty was whether, if the deterioration continued, the dynamics of imports would grow or diminish. The only fact that could be considered typical was that the growth of exports slowed down.

Whether the deterioration of the balance lasted for one or two years depended on the extent of deviation between the actual and the planned balance in the first year of deterioration. If the deviation was of an extent that, as a consequence, a real possibility of indebtedness was indicated, the centre might decide on balance-improving measures already after one year of deterioration. In such cases the phase of deterioration lasted for one year. If the improvement of the balance did not seem absolutely necessary, the deterioration of the balance continued. The situation of the economy in respect of the business cycle is characterized in such cases by continued investment activity. In its wake the sucking effect of domestic utilization increases.* Shortages on the product markets strengthen and become more palpable. From the aspect of the centre, this factor is an important explanatory element of the development of exports in the given year. The centre does not yet deem it important to increase exports, lest it "sucks off" commodities from domestic uses. This contributes to the usually continuing deceleration of exports in the year in question.

The growth rate of *imports* could either increase or decrease. This reflects the ambivalent behaviour of the centre. In view of the fact that in that year the high growth rate of investments and, in consequence, a strengthening overheatedness of the economy were characteristic, the viewpoint of "easing" shortages better asserted itself in the regulation of imports. This effect accelerated imports.

*I set out from the experience that in investment cycles "upswing and halt frequently last for several years, while the setback is usually restricted to one year." [19]

At the same time, the one-sided deviations from the plan can be better felt in imports. It can be traced, through the scheme of the typical cycle, that while exports began to slow down only in the preceding year, imports accelerated not only in the preceding year but already one year earlier. Thus, the processes strengthening the deteriorating tendency of the balance can more strongly be felt in imports both relative to the imports of the preceding year and relative to the exports of the current year. If this tendency caused uncertainty for the centre, the viewpoint of an equilibrated balance might have pushed those of "easing" shortages to the background – in the central system of preferences – when regulating imports. This is why, owing to the increased intensity of import restrictions, imports may have even slowed down in the second years of the phases of deterioration. From the foreign trade processes taking place in the one or two years of the phase of deterioration, the centre perceived that the control of these processes was more and more slipping out of its hands, and the deterioration of the balance could not be stopped without a drastic and direct interference.

The phase of improvement

(The foreign trade measures of improvement)

The first year of improvement

In this year the growth rate of exports increased, while the volume of imports fell.

Let us first examine how the acceleration of *exports* came about. The forcing of exports was not equally "effective" in every group of products. When the value of total exports to the West had to be suddenly raised, the growth rate of exports of agricultural products and materials could successfully be raised in almost every cycle, while in the case of engineering products this rarely happened. The trade in engineering products was almost independent of the cyclical element here investigated. The periods of the agricultural products, however, were strongly synchronous with the periodical fluctuations of total exports to the West. Paradoxically, the centre could best affect the export of those products which were subject to the strictest administrative control on Hungary's most important Western market, the Common Market.

What were the "endowments" of the agricultural and material exports – which the engineering products did not possess – which *usually* allowed their significant boosting from one year to the other whenever this seemed necessary? Four such factors will be mentioneo, not necessarily in an order of importance.*

1. The organizational conditions facilitated the fast procurement of exportable commodities.

*It is improbable that the export interest of producers were stronger in agriculture than in other branches of the economy [20, 21].

In a strongly centralized sales organization it is easier to quickly assess and realize the possibility of regrouping commodities. The agricultural products – which proved to be the "most successful" in the export cycle – had a relatively smooth, established "forced path" from the producer to the external market.*

2. Another domestic condition of quickly expanding exports was the *nature of the product.*

In the case of standard, homogeneous products the centre can relatively faster and more easily explore – than in the case of more differentiated products – the available supply, and the domestic demand, and then compare it with export needs and possibilities.

3. The third factor that could contribute, through accelerating exports, to the relatively smooth functioning of the mechanism described differs from the former ones in that it cannot be interpreted on the microlevel – its impact on the cycle is only palpable on the level of aggregate processes.

As distinct from industry, the *Western import content* of agricultural production *was low* throughout the whole period examined (relative to the average of the national economy). This also meant that the volume of such imports demanding convertible foreign exchange was not a significant burden on the balance. Thus, the balance was not sensitive to the growth rate of agricultural production. Under the given conditions this interrelation was advantageous insofar as whenever an acceleration of exports was necessary it helped (or at least did not render difficult) a fast improvement of the equilibrium position. Owing to the low import content of production, a faster increase of agricultural exports in the phases of improvement never involved a big and sudden increase of Western imports, such as would have endangered the meeting of the short-term demand that exports should grow faster than imports.

The homogeneous nature of the group of products, the forced sales paths, and the relatively low Western import content are internal economic criteria of a fast export growth. These count as advantages "merely" because with their aid a relatively big volume of commodities *can be offered* on the export markets. The fulfilment of these "criteria" is no guarantee that the growth of exports can indeed be successfully accelerated.

Yet these products do become more easily *saleable* on the markets of countries with constrained demand.

4. In a sense, in total sales it was also the "nature" of the product that was an advantage. The continuous sale of more highly processed products, with more differentiated features in respect of quality and technical parameters demands a better microlevel adjustment to the demands of buyers in production and sales – that in the case with products of a raw material nature. (Thus, with the latter it is not the necessary to be competitive – as it is

*In the "relationship between producers and foreign trade it is a *distinctive* feature of agriculture – *as against industry* – that the overwhelming part of agricultural products is procured by trusts, national enterprises and organizations. These store and sort the commodities and then sell them at home or hand them over to the foreign trade companies." [22] – Italics by J.S-V.)

with engineering products – not necessary to see that parts be continuously supplied, not necessary that service should be reliable, and it is not necessary to adjust to the special demands of users etc.)

An important fact is that such products could be successfully exported to the markets of developed Western countries – in the sense that the centre could autonomously influence the dynamism of their exports – in respect of which products the requirements of the buyers were not greater than of those at home.

Let us continue the interpretation of the turnover! In the first year of improvement *imports* fell.

The regular two-year decline of exports in the former cycles, and the attainable extent of export acceleration in the first years of improving the balance, again and again convince those controlling foreign trade that the halting of the process of deterioration not only demands forced exports, but also necessitates a drastic interference with the import processes.

Thus, reduction of the volume of imports became necessary because of the *poor adjustment of the supply side.* It was conspicuous in each cycle that the forcing of exports alone was insufficient for halting the process of deterioration of the balance.

The fact that the volume of imports diminished in the course of a given year affected the development of foreign trade processes in the next year.

The second year of the phase of improvement

In that year both imports and exports accelerate.

Presumably, the acceleration of *imports* can be explained with the increased pressure for imports to serve current production. The pressure is increased by the fact that in the preceding year imports did not simply slow down, but their volume even diminished. In view of the rigid Hungarian import pattern, the reduction of imports could only be implemented by also restricting imports for productive purposes. The acceleration of imports relative to the base year of *declining volume* (negative growth rate) occurs even if the import goods flowing in are merely as much as in the preceding year. This quantity, however, would only be sufficient for a stagnation of production. The safe material supply of production growing at a smooth rate demands, however, a bigger volume of imported materials than in the preceding year.

In view of the high share of materials in the imports from the West, acceleration of imports is almost a necessity in the second year of improving balance.*

The phase of improvement generally lasted for two years. Thus, the requirement of improving the balance usually asserted itself after one year. This is a sign that the extent

*The determination of the freedom of decision of the operative economic leadership became stronger as, with the passage of time, the western import content of current production grew higher. The import already built into production works as an objective condition: if it is missing, it causes disturbances in production and, through the secondary effects, also in domestic supply.

of the improvement in the preceding year was not sufficient for the centre to form the opinion that the danger of indebtedness had been averted. Thus further efforts were made to improve the balance. In the given year this could only be attained through an even higher growth rate of *exports* than in the preceding one. As can be seen, imports continue to accelerate in the year concerned and this produces a result opposing the process of an improving balance. With accelerating imports it is a logical condition of improving the balance that exports should expand at an even higher rate than in the preceding year. From the viewpoint of the centre putting emphasis on growth, the most advantageous solution for improving the balance in the short run is rather the forcing of exports and not, or to a lesser extent, the restriction of imports.* In the final analysis, this preference of the centre was asserted in the second years of the improving phases, when the improvement came about through a simultaneous acceleration of both exports and imports. With regard to the acceleration of exports, it is increasingly characteristic that the forcing of exports to the West pushes every other viewpoint to the background. Of course, if the primary viewpoint is to avert the upsetting of the balance of payments, it is immaterial what kind of products are used in increasing the revenue from exports. On the macrolevel it may seem advantageous to include any new export item into the volume going to the West – irrespective of its use value or cost. Thus the centre generally exhorts the enterprises to boost the volume of exports. It seems unavoidable that viewpoints such as the profitability of exports – which are usually declared – should be asserted in the stimulation of exports to an ever diminishing extent.

*

The instruments used for the improvement of the balance were partly the measures here described, taken in the sphere of trade. Their ensemble constituted the foreign trade "mechanism" of improvement. However, for successful interference – at least in the short run – this mechanism was insufficient.

The armoury of improvement also included the slowing down of the growth of industrial production. After 1965, when the above described characteristics of the turnover cycle asserted themselves in the purest form, the mild fluctuation of industrial production became periodic.**

The regular retardations of industrial production were related to the periodic fluctuations found in the balance of trade with the developed Western countries. The declining rates of production regularly resulted in an improvement of a balance that had been deteriorating until then. [26]

*Analysing the viewpoints of the operative control of the economy, such conclusions have been drawn by László *Antal* [23].

**Relative to the other real processes of the economy, this fluctuation was small. Against the fluctuations in investment, stockpiling and foreign trade, the development of industrial production can be said to be smooth [24, 25].

The "spontaneous" instrument of improvement: the slowing down of industrial production

The phenomenon of this coincidence of events did not come about as a result of a central measure setting the growth rate of industrial output lower in every cycle in order to improve the balance of trade with Western countries. These were usually unplanned declines – and they derived not mainly and not primarily from the interrelations just emphasized.

Yet the periodical fluctuations in output may be traced back, in the last resort, to central actions: to the general restrictive measures (known from the literature discussing the Hungarian investment and stockpiling cycles) and to the import restrictions presented above. These restrictions initially came about under the impact of tensions experienced in the trade with the developed Western countries. This is why – looking at matters from the aspect of central decision-making – we may as well say that the described retardations of production were spontaneous instruments of improvement.

The restrictions of domestic uses may have been directly aimed at boosting exports to the West-beside the intention of easing the tensions becoming acute elsewhere. To this extent, the regularly repeated curbing of the firms' purchasing power may be considered as a deliberate measure aimed at improving the external equilibrium. The centre (also) expected, from the curbing of demand, that the necessity of utilizing the available capacities would turn the firms towards sales abroad. The curbing of domestic uses indeed strengthened the export efforts of enterprises. Under conditions when the markets of the Western economies were characterized by good business conditions and a relatively liberal trade policy accompanied this upswing, the strengthening export efforts actually allowed, *to a certain extent,* the growth of exports not only to the socialist but also to the Western countries.

The turnabouts in the Western balance position, showing an interrelation between improvement and the slowing down of industrial production, came about under the cumulative impact of the curbing of (material) imports and stockpiling. The curbing of stockpiling and imports may have led to the halting of industrial production along at least two lines. It may have led to it partly by causing overall material supply troubles, but also by merely invoking its danger. Knowing such facts, the firms could themselves brake production.

Obviously, a considerable decline in the import of materials may in itself prevent the utilization of capacities. In the Hungarian economy, however, even a relatively minor restriction may lead to material shortages because of the particular expectations of firms. The reduction of continuous imports of materials in the usual amounts – or even the danger of such reduction – may cause troubles even if, for the moment, the total amount of available materials is sufficient. It is a particular feature of the composition of stocks in Hungary that the part of materials stocked by the user firms is disproportionately high. Experience has borne out that the shortages emerging in some areas of production cannot be replaced with the surplus stocks accumulated by other users." The freezing of stocks of materials – particularly of those that are procured against convertible currency – is rational for the firms as long as they feel excess demand on the market of inputs and that access to these products is generally difficult. This behaviour is only further strengthened by the cyclical property of imports – that is, sudden halts are expectable in material supply because the import sources become scarce time and again.

It may be assumed that the regular restrictions of stockpiling processes* start processes similar to those released by import restrictions, and thus lead to a halt in production in combination with them.

The statistical data supply does not allow us to investigate the nature of interrelations between the foreign trade in materials and stocks because in the period examined there were no records of the import content of stocks. It is, however, observable that not only the imports of materials but also the stockpiling processes showed periodical movements. The phenomena indicate that there is a causal relationship between the two periodical movements. The sudden increases of material imports and of stocks show a regular coincidence. [28]

One may also conclude that there is a causal relationship between the periodical movements of foreign trade in materials and stockpiling which occurs in a more indirect manner – but statistically this is better supported regarding long periods. Thus there is an interrelation between the balance of trade and the short-term fluctuations of stockpiling processes.** The assumption that the trade in materials is an important mediating link in this interrelation is supported by the research findings of Katalin *Farkas.**** The curbing of enterprise purchasing power through stock management may thus have been the other "line" of the cumulative processes leading to a slowing down of production.

Concluding remarks

The cyclical development of trade with the Western countries could thus be illustrated with the aid of regularities in the time series of trade with these countries, as well as with those found between this trade and the time series of industrial production. A kind of periodic movement also developed in the trade with socialist countries and this could be shown first of all on the basis of regularities linked to the investment cycle [31]. The emergence of a part of these regularities was linked to a distinct period, i.e. to the

*Examining the cycles of real processes from the aspect of monetary policy, Béla *Csikós-Nagy* expressly speaks about "stockpiling cycles" in [27].

**The central leadership responsible for foreign trade long ago recognized the existence of this relationship and the regularity of mutual impacts: "The development of stocks and of the balance of trade shows a close relationship; in those years when inventories sharply increased the deficit of the balance of trade was also significant, and *vice versa.*" [29]

***The strongest correlation was found between the stocks of materials and the balance of trade. The explanation lies in the big part played by imports in the procurement of materials, (manifest in the stocks of materials) as against exports which do not show in stocks."... "The rapid accumulation (imports) of stocks causes the deterioration of the balance of trade" ... "The deterioration of the balance of trade and its improvement show an inverse relationship with the growth of end-year stock." [30]

one lasting *from the mid-sixties till the mid-seventies.* This points to the workings of a mechanism which, under the given mode of functioning of the economy, through foreign trade eased the product shortages and surpluses which were above the plan and which arose in the wake of the investment cycle. These foreign trade movements made possible a relatively fast and smooth growth of output in the economy. This fast and relatively smooth growth of production can be described using the terms of cyclicality: the relationship between the investment cycle and the trade with the socialist countries, as well as the high-degree regularity of the typical Western trade cycle, could not have come about if world trade had not been characterized by strong expansion in both East and West. This mechanism of movement was based on the fact that, whenever it became necessary, material imports could flow into the economy abundantly, and the relative surpluses of output emerging at the time of growing investment could be placed without obstacle on the socialist market; and the volume of exports necessary for restoring the external equilibrium, which was usually unstable, could also be placed on the Western markets. This period might be called a "stable" one.

In the cyclical movement of foreign trade, as well as in the regularities in the majority of interrelations between the volume processes of foreign trade and the internal real processes (in the functional mechanism of the short trade cycles), there occurred breaks in the mid-seventies. Functional troubles arose in this mechanism. Nevertheless, the end of the stable period cannot be linked merely to the changes on the world market, much less can it be traced back to the price explosion. Two factors at least as important were, in this respect, the modification on the side of the socialist trading partners and the changes of era in the world economy.

In practice, the working of these cycles strongly assumed and still assumes each other's existence in the complicated interrelations of the real processes. The changes in one of the markets influence, through these links, the trade on the other market, cause disturbances in the mechanism here presented and, owing to the big weight of foreign trade in Hungary, they are determinative for the functioning of the whole economy.

The domestic springs of movement – as regards the tendencies in the trade with the developed Western countries deriving from the functioning of the domestic economy – invariably worked towards maintaining the mechanism of cyclical movement. Its survival was founded and helped by the invariability of the growth policy,* and by the fact that

*One of the most important specific Hungarian features of the period between 1973–1978 was that with an almost 20 percent deterioration in the terms of trade, national income increased by an annual average of 5.6 percent, and the quantity of imports increased by about 8.5 percent. A deterioration of the terms of trade was in itself a widespread phenomenon in the world economy; and the acceleration of growth and a simultaneous expansion of imports were not rare occurrences in the countries favourably affected by the world economic changes, nor were they in those countries strongly relying on imports of capital. However, an acceleration of growth – with a major deterioration of the terms of trade – was an unambiguously Hungarian phenomenon by international comparison. [32]

this economic policy also remained unchanged in that it continued to rely on cooperation with the socialist countries, in the same way as during the stable period.*

The external conditions which secured a relative stability for the functioning of the mechanism of movement persisted for a very short time in a historical perspective. It is very likely that they will not return; this statement can safely be made even without any further study of statistics.

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*Köves–Oblath [33] emphasize the invariability of this feature of economic policy in Hungary and state that this concept "prevailed at least up to 1978."

The following statement of similar content, though relating to the narrower field of planning – was even made later: "In fact, we have not yet asked the question what fundamental changes are to be made in the planning system, if East-West trade gains more importance in economic growth."[34]

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"ЦИКЛЫ ОБОРОТА" В ТОРГОВЛЕ ВЕНГРИИ С РАЗВИТЫМИ КАПИТАЛИСТИЧЕСКИМИ СТРАНАМИ

Ю. ШУБА-ВАРГА

Начиная с 1960-х годов венгерская экономическая политика систематически стремилась преодолеть вызываемые инвестиционными циклами нарушения сбалансированности производства с помощью внешнеторговых каналов. Во внешней торговле как с социалистическими, так и с капиталистическими странами также наблюдались связанные с инвестиционными циклами колебания подобной периодичности.

В торговле Венгрии со странами рыночной экономики можно было выделить такие особенности, которые привели к несовпадающему по времени с инвестиционным циклом и с периодическими колебаниями оборота с социалистическими странами циклу. В первой части статьи автор знакомит со специфическими особенностями, которые наблюдались в период между 1950—81 гг. во временных рядах, показывающих темпы роста импорта и изменения сальдо, а также между этими

временными рядами. Из этих особенностей можно было констатировать как складывалась динамика экспорта и импорта, характеризующая улучшение и ухудшение сальдо в отдельные годы. На их основе можно было дать типично циклическую картину. Из „типично циклической" картины вырисовывались признаки своего рода механизма движения. Основными движущимися пружинами этих периодов продолжительностью в среднем четыре года были нарушения сбалансированности, а также реакция на это оперативного управления и воздействия инвестиционного цикла.

Во второй части статьи автор показывает, как воздействовали основные движещие пружины в отдельные годы типичного цикла на динамику экспорта и импорта, а также то, что характеризовало в это время товарную структуру оборота.

С середины 1960-х до середины 1970-х годов этот механизм в соединении со сложившимися в цикличности торговли с социалистическими странами механизмами — был способен компенсировать нарушения сбалансированности выпуска продукции в связи с изменениями конъюнктуры без обострения несбалансированности и возникновения — несмотря на систематические рестрикционные меры — более тяжелых нарушений в материальном снабжении производства. Одним из условий одновременного сохранения внутреннего и внешнего равновесия было снижение темпов роста промышленного производства в периоды улучшения баланса.

И наконец, автор делает вывод, что, во-первых, необходимые для успешного функционирования этих механизмов внешние условия — быстро расширяющиеся и не подверженные резким изменениям экспортные и импортные рынки как на Западе, так и на Востоке — имели место лишь в течение исторически краткого периода. Во-вторых, эти инструменты не были способны ликвидировать те прочные напряженности, в результате которых трудно поддерживать сбалансированность в торговле со странами рыночной экономики не только в период ускорившегося роста, но и в период стагнации экономики.

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FORMS OF ECONOMIC MOTION

A. BRÓDY–M. FARKAS

Both the numerical results obtained with the aid of the Goodwin model of cyclical economic growth and the qualitative description of the movement can be significantly improved by using the latest mathematical results attained with Volterra-type ecological models. Relying on them, the model is modified and more realistic, though somewhat more complicated assumptions, are introduced. As a result, the model can be filled with data relating to the Hungarian economy, and can be used for interpreting the economic movements.

Economic literature contains three views concerning the behaviour of economic systems. The first view, originating with A. *Smith,* maintains that the market secures a stable equilibrium. A time series may exhibit random shocks but its equilibrium path will soon be restored. According to K. *Marx* all growth paths are intrinsically cyclic and equilibrium can be found only as an average of past cycles. Finally, since *Slutzky* [12] and the advent of modern statistical methods, we assume that random causes render the behaviour fundamentally chaotic. The interdependencies are overshadowed by a "white noise"; cycles are more apparent than real, each and any cycle-length being one of the components of the time series: the motion is random without a manifest or discernibly sharp periodicity.

The enquiry which follows brings the surprising result that these mutually exclusive views can be reconciled, showing that the different time paths are just forms of motion of the same basic system of interdependencies.

The original model

Goodwin [6] started avowedly from Marxian principles: the growth of the rate of profits triggers production and thus an excess demand on the labour market. Hence wages rise, squeezing the rate of profits and slowly eroding the basis for accelerated accumulation. Business activity must now shrink and employment drop till wages, depressed by mounting unemployment, reconstitute the original high rate of profits.

To express the alternating ups and downs mathematically, Goodwin turned to the predator-prey model of *Volterra.* Let us explain his original approach in setting up the model.

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If all of national income could be accumulated, then its growth rate would be only constrained by capital intensity. Capital intensity shows how many years of income have to be tied up (as stocks) to produce a unit of income. Its reciprocal value, let us designate it by α, "capital productivity", expresses the amount of national income generated by each unit (say 1 Md) of capital invested.

The rate of growth of national income equals the rate of growth of employment—unless there are changes in labour supply and technology. We assume here with Goodwin that the latter are exponential processes with exponents which are, in first approximation, constants: $\varkappa$ per cent per year rise in labour productivity and λ per cent per year rise in labour supply. Then the rise of employment (let us designate employment by N_1 and its yearly growth rate by $\dot{N}_1/N_1$) can be determined as:

$$\mathring{N}_1/N_1=\alpha-\varkappa-\lambda=\varepsilon.$$

The actual growth rate of employment will be lower because part of the national income has to be spent on wages and salaries—only the remainder can be accumulated. Goodwin applies the classical notion of real-wages (these were defined by Ricardo and Marx as the wage share of national income—thus they have not much in common with the modern notion of real wages which measure the amount of products and services purchased by wages). This share—in Keynesian parlance, the propensity to consume—is designated by N_2, and its opposite, $1—N_2$, is the rate of savings. Thus the first equation of the model is:

$$\mathring{N}_1=(\varepsilon-\alpha N_2)N_1. \tag{1}$$

The second equation is established even more simply by Goodwin. The change of the real wage (propensity to consume) hinges on employment. We do not know the exact functional form (the so-called Phillips curve) but perceive that the rate of employment and the real wages are positively correlated. Employment fluctuates between fairly narrow limits in real life, so it is permissible to linearize the interdependence in a small neighbourhood of equilibrium and consider a straight line with slope β and (negative) intercept γ. These will be "large" numbers, as Goodwin puts it, and thus:

$$\mathring{N}_2=(-\gamma+\beta N_1)N_2. \tag{2}$$

This model (1)–(2) is well known and is discussed in mathematical literature (See f. i. [10]). Beside the trivial $(N_1, N_2)=(0, 0)$ solution it has a centre at $(\gamma/\beta, \varepsilon/\alpha)$—stable but not asymptotically stable in the Liapunov's sense. In the neighbourhood of the centre, the (linearized) system oscillates with a wavelength of $T=2\pi(\varepsilon\gamma)^{-1/2}$. Averaging its motion for a cycle will yield the "equilibrium" values of the centre. Thus equilibrium can indeed be considered as the average of past motion, as Marx assumed it.

Computation with Hungarian data from the period 1950–80

We can easily implement this model, since all the data can be gleaned from the 1980 yearbook of the Hungarian Statistical Office [11]. (In parentheses the respective page-numbers are given.)

a) capital productivity

Net national income 626 Md* (p. 85). Total reproducible stock 2447 Md (p. 101), thus $\alpha = 0.26$.

b) labour supply

According to data (p. 53) the very slow growth always remained below 1/2 per cent per year and could be neglected, thus $\lambda = 0$.

c) productivity

National income increased 4.76-fold during the 30 years (p. 5), yielding a yearly average growth of 5 per cent. However, part of this increase stems not from genuine improvement of technology but from labour being reallocated from agriculture towards industry, the latter characterized by much higher markups. Thus the illusion of a faster rise of productivity than in reality originates in the severely distorted price system. A more conservative estimate of the increase in productivity can be computed by averaging the increase in the separate branches of the economy, thus excluding the bias created by preferential industrial pricing (see f.i. Halpern–Molnár [8]). Our estimate is therefore $\varkappa = 0.03$.

d) employment

The gainfully employed (p. 4) fluctuated between 40 and 50 per cent as part of total population (p. 53). We know that on the free labour market additional labour can be hired only at a fivefold rate of the average earnings. While in the state-owned construction industry an unskilled labourer earns about 200 Ft per day, his salary in private construction will be about 1000 Ft per day, the same rates for skilled work (plumber, electrician, bricklayer etc.) will be 300 and 1500 Ft respectively. This yields only a very hazy approximation to our "Phillips curve" but, alas, we lack proper

* Md = 10^9 Forint.

econometric research on employment and wages in socialist countries for the time being. Thus our estimate will be $\beta=5$ and $\gamma=2$.

e) real wage rate

The gross amount of wages and salaries (p. 85) being 320 Md, dividing it by the already quoted net national income of 626 Md yields a surprisingly low value for real wages, being 0.51 and indicating an almost 100 per cent markup after wages.

If we now put our data into the original model, we obtain the following solutions:

Average employment $\bar{N}_1=\gamma/\beta=0.4$.

This rate is fairly realistic. Still it has not much explanatory power because of the crude estimate of our employment-wage relations.

Average wage rate $\bar{N}_2=\varepsilon/\alpha=0.88$.

This rate deviates from the actual one, 0.51.

Cycle length $\bar{T}=2\pi(\varepsilon\gamma)^{-1/2}=9.26$ years.

This too is unacceptable. We know or at least suspect a shorter "inventory cycle" of about 4 years, a longer "equipment cycle"—that can be traced in the movement of the data for machinery and equipment (see [1] and [14])—of 12 years, and there are traces of a one and a two generation demographic swing (of 25 and 50 years duration). The length computed above does not come close to any one of them. So we must try to improve our model.

A revised model

Goodwin hinted in later work [7] at the "structural instability" of the original model. This means that very small perturbations may lead to qualitatively different behaviour. This instability can be remedied by slight but important changes in the set-up. (By the way, it strikes us as farcical that the "prey" of the model is the economy itself—its "predator" being the worker.) Reduction of the wage rate, N_2, to zero secures the fastest growth rate:

$$N_1(t)=N_1(0)\cdot\exp(\varepsilon t),$$

being a mathematically unobjectionable but highly misleading solution of the original model. It makes sense only if N_1 remains below 1, employment of the total population being inclusive of adolescents and newborn babies—the delusive dream of the military HQ in a total war. It is rather ironic how the Marxian tenet of worker-capitalist antagonism leads—by dogmatic and faulty reasoning—to such a staunch anti-worker attitude (alien neither to usual growth theories nor to brutal "big jump" policies).

It should be clear that, employment N_1, cannot be augmented without limits and severe penalties. The original model assumes, erroneously, that additional workers will be just as productive as the already employed population. But even a cursory glance at reality shows that while, in the downswing, reduction of employment bids farewell to the less trained, less dexterous, less productive labourers, in the opposite case the upswing has to accept what it finds on the labour market: less knowledgeable, often untrained and undisciplined people with inferior skills.

We do not yet have dependable data about the spread of personal productivities (whatever we know about it indicates a quite impressive range), but we certainly will enhance the realism of our model if, instead of $\mathring{N}^1 = \varepsilon N_1$, we assume logistical saturation of productivity—that is $\mathring{N}_1 = \varepsilon(1 - N_1)N_1$. Thus with 50 per cent employment we obtain a point of inflection—over this point productivity drops absolutely, while the logarithmic derivative continuously decreases from $N_1 = 0$ to $N_1 = 1$, where it reaches zero. This will describe employment which cannot surpass 1, and habitually remains under 0.5, as it usually does. We hope this argument shows the fallacy of "total employment" policies that do not consider the economic results which can—or cannot—be achieved by a given increase in employment.

A second, also more realistic assumption relates to the reaction of wages on employment. This cannot be instantaneous—it needs time to work itself out. It is well known that certain delays are operative, thus in a recession the wage rate reacts sluggishly to the mounting unemployment—real wages may actually rise for a while in spite (or just because) of unproductive workers being fired. The lowest real wage will be attained when the upswing has already started. This delay will be, in all probability, somewhat longer in planned than in market economies because the former's wage-bargaining apparatus is less developed. We know of cases when only years of persistent shortage on the labour market triggered adjustment (as in the case of bus drivers, spinners and weavers etc.).

This delay can be modelled by substituting into equation (2) some weighted average of the past movement of N_1 instead of the simple contemporary value of employment. As a weight function $G(t-\tau) = a\exp(-a(t-\tau))$ can be suggested with $a > 0$ constant and $-\infty < \tau < t$.

This means that we consider a "$1/a$" delay—or discount past employment by the discount rate "a".

That is, instead of N_1 we substitute into equation (2):

$$N_3(t) = \int_{-\infty}^{t} a \exp(-a(t-\tau))N_1(\tau)\, d\tau. \tag{3}$$

So our equations (1) and (2) will be transformed to

$$\begin{aligned} \mathring{N}_1 &= \varepsilon(1-N_1)N_1 - \alpha N_1 N_2 \\ \mathring{N}_2 &= -\gamma N_2 + \beta N_2 N_3, \end{aligned} \tag{4}$$

where N_3 is given by equation (3). This is a seemingly complicated system of integro-differential equations. This system—as an ecological one—has been investigated by *Farkas* [2, 3], *Szabó,* [12], *Farkas* A., *Farkas* M., *Kajtár* L. [4], *Farkas* A., *Farkas* M., *Szabó* [5].

The literature quoted shows that the system can be simplified (is equivalent) to the following three dimensional ordinary differential equation system:

$$\begin{aligned} \mathring{N}_1 &= \varepsilon(1-N_1)N_1 - \alpha N_1 N_2 \\ \mathring{N}_2 &= -\gamma N_2 + \beta N_2 N_3 \\ \mathring{N}_3 &= a(N_1 - N_3). \end{aligned} \tag{5}$$

The latter system allows a straightforward economic interpretation. In Hungarian planning we can assume that wages will be set not according to actual, employment N_1, but according to *planned* employment N_3. Planning, as a continuous learning process now corrects the plan according to the discrepancy of plan and reality, as expressed by the last equation. The correction factor "a" is the same as the previously considered discount factor, the reciprocal of delay, as is well known from the theory of "exponential smoothing" and "divided differences".

Turning now to system (5) we may claim the following knowledge: besides the trivial $(\bar{N}_1, \bar{N}_2, \bar{N}_3) = (0, 0, 0)$ solution, it has a $(1, 0, 1)$ solution which is asymptotically stable if $\gamma > \beta$. This is again the case of zero wages.

It is not realistic, because if $\gamma > \beta$, then the Phillips curve indicates a wage decrease even with total employment. Practically therefore

$$\gamma < \beta \tag{6}$$

and in this case we have a third equilibrium which is

$$(N_1, N_2, N_3) = (\gamma/\beta, (1-\gamma/\beta)\varepsilon/\alpha, \mathrm{g}/\beta). \tag{7}$$

As we see the equilibrium position does not depend on the delay $\mu = 1/a$—but its stability will be decisively influenced. If namely

$$\beta(\beta-\gamma)-\gamma\varepsilon<0, \tag{8}$$

then the equilibrium (7) will be assymptotically stable however large our delay. (This case will be reached, with $\beta-\gamma>0$ because of (6) only if ε, the productivity of capital is very high. Thus this again is a proposition seldom encountered in real economic life). If however:

$$\beta(\beta-\gamma)-\gamma\varepsilon>0 \tag{9}$$

(which also implies (6)) then with a small delay equilibrium will be stable, and with larger delays, unstable. More exactly, if besides (9) also:

$$\mu\left(\beta-\gamma-\frac{\gamma\varepsilon}{\beta}\right)<1 \tag{10}$$

pertains, then equilibrium is asymptotically stable, while if:

$$\mu\left(\beta-\gamma-\frac{\gamma\varepsilon}{\beta}\right)>1, \tag{11}$$

then it will be unstable.

This is then a case in which lengthening of the delay destabilizes a system—a common, but not always true rule of thumb. Theoretically all the parameters may change, and—from equations (10) and (11)—it follows that the same destabilizing feature may belong to the increase of β and the decrease of γ and ε. Stability is lost if—while (9) remains valid—we cross the surface $\mu(\beta-\gamma-\gamma\varepsilon/\beta)=1$ in the four dimensional space of ε, γ, μ, β.

This loss of stability is an Andronov–Hopf bifurcation (see f.i. *Hassard; Kazarinoff; Wan* [9]) meaning loosely that, in the neighbourhood of the critical parameters, periodic solutions appear with small but increasing amplitudes. Beside degenerate cases there are two typical situations. The bifurcation might be *soft* or *supercritical,* if this periodic solution appears for unstable parameter values (11). In this case the bifurcating periodic solutions are *orbitally asymptotically stable*. If now these small amplitude oscillations appear in the stable domain (10), then the bifurcation is *hard* or *subcritical* and the oscillations are not stable. There still may appear stable periodic solutions in the non-stable domain, but their amplitude will be large (the fluctuations are hard).

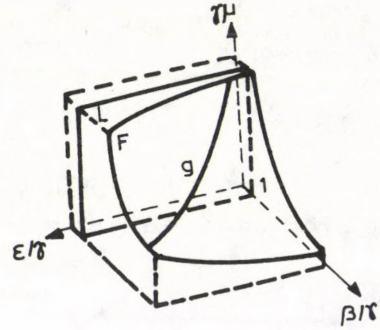

Fig. 1

Bifurcation in $(\varepsilon/\gamma,\ \beta/\gamma,\ \gamma\mu)$ space

Explanation. (Assuming $\gamma=1$, our variables are ε = capital productivity, β = partial derivative of wages with respect to employment, μ = delay.) In the domain in front of the vertical plane L there exists an equilibrium in which all coordinates are positive. Behind the surface F this equilibrium is stable (10) and unstable otherwise (11). The surface is divided by the curve g. Under this curve (12) is positive, above it negative. The loss of stability is "hard" if we cross the surface F above g.

For the functioning of the economic system the *soft* loss of stability must be preferred. We can make the conditions of such a case explicit (see *Farkas; Farkas; Szabó* [5]). If, at the point where the inequality (10) is replaced by equality, and then at the same time by the opposite inequality (11):

$$2\beta-\gamma(\gamma(8\varepsilon^2+9\varepsilon\gamma+2\gamma^2)/(\varepsilon+2\gamma))^{1/2}>0, \tag{12}$$

Then the loss of stability is smooth and it is hard if the inequality (12) is <0.

Numerical results

Our improved model does not require additional data, therefore its results are computable without further ado:

Equilibrium employment $N_1=\gamma/\beta=0.4$, as before.

Equilibrium wages $N_2=(1-\gamma/\beta)\varepsilon/\alpha=0.528$.

This means a marked improvement and is quite close to the actual 0.51.

Inequality (9) obtains, because of $\beta(\beta-\gamma)-\gamma\varepsilon-14.54>0$. Thus, our equilibrium will be stable, with a delay, as computed from equation (10), if $\mu<0.344$. That is, if wages react on employment within a roughly four month period, then we cannot expect cycles. If reaction time increases, then we may expect fluctuation in employment and wages (and, of course, production itself). The left hand side of inequality (12) is now $5.56>0$. This means that if the delay is larger than four months but not too long, then stable cycles appear, with smallish amplitudes and a cycle length (see [2]) of:

$$T=2\pi(\varepsilon\gamma(1-(1+\varepsilon/\beta)\gamma/\beta)^{-1/2}=12.15 \text{ years.}$$

This is quite close to one of the already mentioned Hungarian cycles.

If the delay keeps increasing then the cycle length is altered and further bifurcations may appear, leading principally to more and more chaotic motion.

An approximation can be given for the amplitude r of the fluctuation in the neighbourhood of $\mu_0=0.344$.

Namely (see [9] p. 91, [2] and [13]):

$$r=A(\mu-\mu_0)^{1/2},$$

where

$$A=2\frac{\beta^2-\gamma\beta-\gamma\varepsilon}{\beta^2(\beta-\gamma)}\left[\frac{\gamma(\beta^2-\gamma\beta-\gamma\varepsilon)(4\gamma\varepsilon(\beta^2-\gamma\beta-\gamma\varepsilon)+\beta^2(\beta-\gamma)^2)}{\beta(2\gamma(\beta^2-\gamma\beta-\gamma\varepsilon)+\varepsilon(\beta^2-\gamma\beta-2\gamma\varepsilon))}\right]^{1/2}$$

This yields in our case:

$$r=1.90(\mu-0.344)^{1/2}.$$

That is, if the delay happens to be 0.4 the amplitude will be 0.45, a half year's delay already causing an amplitude of 0.75, not encountered in economic systems.

To sum up our verdict on the Hungarian economy: in all probability it behaves rather chaotically most of the time (or: most of its interdependencies are fairly chaotic) on account of the long delays caused by its hierarchic and bureaucratic structure. The remedial action has to consider drastic decisions to speed up reaction and shore up internal communication.

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О ФОРМАХ ДВИЖЕНИЯ ЭКОНОМИКИ

А. БРОДИ–М. ФАРКАШ

Мы можем значительно улучшить как количественные результаты модели циклического роста экономики, восходящей к Гудвину, так и качественное описание движения путем использования более новых математических результатов, достигнутых в области экологических моделей типа Вольтерра. Опираясь на это, мы видоизменим модель, введем зависимости, основывающиеся на более реальных гипотезах, хотя и несколько более сложных. В результате этого модель может заполнена данными, относящимися к венгерской экономике, и использована для интерпретации движения в экономике.

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THE SPREAD OF BRIBERY IN A CENTRALLY PLANNED ECONOMY*

P. GALASI–G. KERTESI

The paper seeks answer to the question: what mechanism generates the spreading of bribery and what consequences it has on the position of buyers engaged in corruptive practices and of those refraining from them. The paper examines the problem with the aid of a simple microeconomic model. The main findings are as follows: assuming rational, utility-maximizing, perfectly informed buyers and originally honest but corruptible seller, a corruption process will start. And then, sooner or later, merely on utility considerations, a considerable part of buyers, in certain cases all of them, will choose the alternative of corruption. From certain points in the spreading of corruption not only those refraining from corruption but also those practicing it will be worse off than if there had been no bribing in the market—yet corruption keeps on spreading. The paper continues with listing the market of some empirically important products where the mechanism outlined in the model can generate corruption. Finally, it formulates the statement that the most important cause of spreading corruption is one of the system-specific features of socialist economy: the (structural) inelasticity of supply.

Corruption is an everyday phenomenon for Hungarian households. We frequently experience that a number of goods are unobtainable unless a bribe ("speed money", "thank you money", tip) is paid. It seems that corruption occurs with growing frequency and that the bribe is higher and higher. It also seems that this increasing corruption overcharge buys us less and less advantage: we stand to lose if we take part in corruption just as well as if we do not. In some cases we do not gain anything by paying a bribe, yet we suffer serious disadvantages if we do not. We are suspicious: corruption does no longer induce anyone who is in a position to favour us to do so; we are unable to improve our position as buyers or even to put a brake on the deterioration of this position. The above detrimental and yet seemingly unavoidable phenomena prompt us to seek a causal explanation.

Explanations on the subject are, however, of an *ad hoc* character: they are either based on uncertain arguments or draw hasty conclusions from known facts. Some argue, for instance, that certain jobs pay very little or the persons in these jobs are greedy and individualistic which motivates them to accept (or to press for) a bribe; or that the price of goods is too low (under the "market price"); or that in the market the

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seller is better informed than the buyer and, therefore, he is in a position to cheat the latter; or that there is a corruption psychosis in the market: buyers generate corruption in the hope of obtaining better quality and/or obtaining it sooner by paying more than the official price; or that a segment of buyers have too high an income, therefore they do not value money much and are willing to pay any amount of bribe and thus trigger corruption.

In this paper we shall establish that the conditions of the above *ad hoc* explanations are not necessary for the existence and spreading of corruption. We will show that corruption occurs even if buyers are rational and seek to maximize their utility; are perfectly informed about the price and quality of the products, and, in shortage situations, about the waiting time. We also assume that sellers are originally honest but it is possible to corrupt them, and we disregard the assumptions concerning the low price of goods and the income of actors. Our central proposition is the following: once corruption is generated in a market within the given institutional setting a significant proportion of buyers will opt for corruption, and in certain situations all buyers will do so. And although from some given points onwards not only those who refrain from corruption but also those who pay bribes will be worse off than they would be in a corruption-free situation, the number of bribers will continue increasing. Thus, corruption serves as an example of how individually rational choices may lead to collectively irrational outcomes.*

We analyze households' purchases in the first economy. We disregard bribery in the second economy as well as corruption aiming at winning favours from state authorities. Neither do we deal with interfirm corruption in the first economy.** We only treat transactions where the buyer pays a bribe above the official price to the employee of the marketing organization of the given products or services in order to obtain selective advantage over the rest of buyers, whatever the substance of this advantage.

The speading of corruption is analyzed with the aid of simple microeconomic models. Our assumptions are simplistic insofar as every model needs to simplify. We apply an *a fortiori* logic of argumentation: if corruption affects a given proportion of buyers within the framework of the model and it has negative consequences for buyers

* We have analyzed how individually rational decisions may lead to collectively irrational outcomes through the example of "perverse competition" between the producers of the state sector and the second (informal) economy (Galasi and Kertesi [8]). In its approach and method the present paper directly follows this previous one.

**From the economic literature on corruption, we mention *Rose-Ackerman*'s [18] comprehensive book, *Becker* and *Stigler*'s [5] study which deals with bureaucratic corruption in capitalist economies; certain chapters of *Rupp*'s [19] book, and *Montias* and Rose-Ackerman's [16] study which gives a theoretical account and international comparative study of corruption in socialist economies. In the Hungarian literature we have found only two comprehensive works: *Hankiss* [11] and *Ádám* [2].

in general, then under more realistic conditions it affects a larger proportion of buyers and implies even more serious disadvantages.

We will present two models. The first is a static one: it describes the structure of a corruption situation, the options open to buyers and the consequences of their choices by using the simple tools of game theory. The second model is a dynamic one: it shows the spreading of corruption in a market where the purpose of corruption is to obtain better quality. As examples, we shall identify some markets where corruption spreads through mechanisms described in the models. In the end we shall draw some conclusions about the sufficient conditions of the spreading of corruption.

1. The example of the "extra espresso"

Let us begin with an example given by Elemér Hankiss which he cited in order to shed light on the catch inherent in corruption situations ([11] pp. 123–125). In his example the official price of an espresso is three forints and in a coffee shop one gets three forints' worth of coffee. However, there emerged the institution of the so-called "extra espresso": those customers who wish to have a better (stronger) coffee pay two forints more. This amount goes to the waitress who makes the coffee and who, in turn, prepares a five forints' worth of espresso for the bribers. Since she only has so much coffee in stock which she gets through official channels and she does not steal, the transaction is possible only if she "economizes" on the coffee given to non-bribers. Thus those who pay the official price (3 Forints) only get one forint's worth of coffee. The waitress fares well since she earns an extra two forints for every briber without any extra work or cost. The bribers also fare well since they get 5 Forints' worth of coffee for their five forints, while if they had paid three forints they would have got one forint's worth of coffee. On the other hand, non-bribers fare badly since they get one forint's worth of coffee for three forints. "Not only the bribee but also the briber gains at the expense of others (if he gains at all, and not only gets average service in spite of paying a bribe). At the expense of those who are unable or unwilling to hand out tips or bribes"—Hankiss concludes ([11] p. 125).

The above example is witty and simple. However, let us construct a game-theoretical model and see if it really contains all the elements of the situation. Do bribers really gain anything? And if not, is this purely accidental?

We have two buyers: A and B. Both may choose between two strategies (alternatives): they either only pay the official price—three forints—(strategy A_2 and B_2), or they pay the two forints extra which comes to five forints (strategy A_1 and B_1). Both actors' choices are influenced by the choice of the other. The standard assumptions of game theory apply here: both actors are fully informed, both are aware of the possible outcomes of their choices, and both know that the other knows this. We have constructed two pay-off matrices. The first contains the values of the quality of coffee resulting from the different strategy pairs; the second contains the net utility of the actors (receipts minus costs; in the coffee-example: the received quality minus the price paid). In the following the former is called *quality matrix* and the latter *utility matrix*. Each cell of the matrices contains two figures. The figures in the lower left corner represent the pay-offs of actor A while the ones in the upper right stand for the pay-offs of actor B.

We have added a couple of constraints to the Hankiss example. 1. The waitress is originally honest. That is, if *no one* corrupts her, she gives everyone three forints' worth of coffee for three forints.* 2. Since she has a constant amount of coffee at her disposal, if *everyone* corrupts her she will lack the necessary inputs for making better (stronger) coffee, and therefore she will provide the original (official) quality. Assuming rational customers, which of the possible four outcomes will prevail? In order to answer the question we have to analyze the problem from the point of view of both actors and we have to take into account *both* criteria (quality and net utility).

Table 1

The example of te "extra espresso": the pay-off matrices of customers

quality matrix

	B_1 (Ft 5)	B_2 (Ft 3)
A_1 (Ft 5)	3 3	1 5
A_2 (Ft 3)	5 1	3 3

utility matrix

	B_1 (Ft 5)	B_2 (Ft 3)
A_1 (Ft 5)	−2 −2	−2 0
A_2 (Ft 3)	0 −2	0 0

Based on the values in the *quality matrix*, it is more advantageous for actor A to pay the 2 forints extra (strategy A_1) since his pay-off will be higher than in the case of strategy A_2 (i.e. refraining from corruption) whether his opponent pays a bribe

* It is easy to see that the outcome of the game will be the same even if the waitress was originally corrupt, i.e. if she initiated the corruption. This means that the pair of strategy A_2B_2 will bring 1 Ft's worth of coffee for both customers, which is equal to -2, -2 net utility. In this case A_1B_1 is dominant strategy pair from the point of view of both the quality and the utility matrix (of course, only if she provides at least an appropriate quality to bribers). Therefore these options will be chosen. By assuming our "originally honest" waitress we attempted to show that it is *not a necessary condition* of corruption that the seller should decrease the quality of goods or services thereby forcing customers to pay bribes.

(strategy B_1) or not (strategy B_2). Thus from the point of view of A, A_1 is dominant strategy. The position of actor B is completely symmetrical to that of actor A. Therefore, he will choose to pay a bribe out of the very same considerations (to him B_1 will be dominant strategy). This means that rational actors will realize the A_1B_1 strategy pair when quality is the criterion of their choice. From the point of view of their *combined* net utility, however, this outcome is the *least advantageous* one.

According to the *utility matrix* strategy pair A_1B_1 yields a combined net utility of -4, while in the case of strategy pair A_2B_2, when neither of the actors tries to corrupt the waitress, the combined net utility is zero. This is the collective optimum of the game. In this case both actors' net utility is zero and both get three forints' worth of coffee for three forints. To be sure, this result would come about only if the actors cooperated, which is highly improbable, since they do not know each another. There is always a risk that the other actor (A or B) will act upon his aspiration for better coffee and will choose strategy A_1 or B_1 respectively and the other actor—choosing strategy A_2 or B_2—will be worse off as to both quality and utility.* And since they both know this—both are perfectly informed—they will try to "preemt" the other in achieving this advantage. It is highly probable, therefore, that they will both opt for corruption which leads to an irrational outcome as far as their combined net utility is concerned.**

In the following we will generalize the Hankiss-model to n actors and with a dynamic model we will analyze the conditions and the probability of this latter outcome.

2. A dynamic model: paying bribes for better quality

We will examine the market of a single good. In the market of the given good there is equilibrium in terms of quantity and shortage in terms of quality. This means that buyers get the required quantity without having to wait but the quality of the offered good—measured by the amount of inputs used in its production—is worse than the one the buyers would like to purchase. The same buyers come to the market and buy the good with a certain (daily, weekly, monthly) regularity. The total quantity of the good—disregarding changes in quality—and the aggregate quantity of inputs is constant over time. Each customer buys a uniform quantity of the good: officially, the good is available in a homogeneous quality. More precisely: the marketing organization does not make a distinction among the various poten-

* All the more so since, from the aspect of net utility, strategies A_1 and A_2 or B_1 and B_2 are completely identical for actors A and B *individually*. Based on the utility matrix, assuming uncoordinated individual strategies, the problem remains unsolved.

** This is a special case of the "prisoner's dilemma" game. See in general: *Luce-Raiffa* [15] pp. 94–97.

tial qualities of the good.* However, the employee of the marketing organization who is directly in charge of the sale of the good—the seller—is able to exert an influence, within certain limits, as to what quality each buyer will get. This implies that the seller is able to influence the quality of the good by reallocating or transferring inputs.** Accordingly, if the good contains less than the prescribed quantity of inputs, it is worse than the official variant, if it contains more, it is better.*** The officially homogeneous good has a uniform price.⁺ We assume that if there is no corruption in the market this 'rice "corresponds" to the official (average, customary) quality.⁺⁺

On the supply side there is one single firm (or non-profit institution), which, for simplicity's sake, is represented by one seller. This may seem to be an essential assumption and one restricting the validity of the model since this way competition is ruled out on the supply side. At the same time it is clear that it is not this above assumption that rules out competition; rather, it follows from two previous—and realistic—assumptions. In a market, where 1. there is no excess supply and 2. the good is offered in uniform quality, at an officially fixed price, the presence of more than one firm does not make much difference, the behaviour of these firms would not differ greatly from that of a monopoly firm which has no competitors.⁺⁺⁺

* The fact that no differentiation is made among the different variants of a heterogeneous product may have several causes. For instance: 1. the differentiation and different pricing may involve higher costs than the profit gained from the sale of the more expensive, better quality. 2. The marketing organization or the regulating authority attempts to supply the given good in uniform quality since (e.g. out of egalitarian considerations) it does not wish that income differences among households should be reflected in the consumption of the good because of different prices.

** In the case of services such inputs may be time, attention, care. These, just like physical inputs, are also scarce resources, one has therefore to economize with them. Similar is the situation when the officially uniform quality is varied in reality. The seller will then not transfer inputs but decide whom to supply with the higher or lower quality. Corruption aims at obtaining better quality.

*** Here and in the following we assume that buyers measure precisely—say on interval scale—the quality of the good or service.

⁺ This price, in the case of certain ("merit") goods, may be such that it does not even cover the costs. It may also be zero as in the case of the so-called "free-allowances"; then the marketing organization is not a firm but a non-profit institution since its finances, partly or totally, come from the government budget.

⁺⁺ In the case of zero price this means that to the official price there belongs, by social norms, a customary, accepted standard quality which corresponds to the given use of the necessary inputs.

⁺⁺⁺ When *quality* is *uniform* and *prices* are *fixed*, the means of competition are lacking, there is simply *nothing to compete with*. *In lack* of *excess supply* (in equilibrium markets) there is no point in competing, there is simply *nothing to compete for*. Losing positions on the supply side of the market are necessary conditions of competition: producers who are pushed out of the market because of insufficient demand, and goods which cannot be sold. Firms compete precisely in order to avoid getting into these losing positions. In equilibrium markets there is no point in competing, since all the goods can be sold. The notion that some excess supply is a necessary condition of competition, in the economies of socialism was, to our knowledge, first formulated by János Kornai. However, Kornai emphasizes only one implication of the relative oversupply, namely that producers always have sufficient mobilizable slack so as to flexibly adjust to the unforeseen shifts in demand ([12], pp. 176–178 and [13] pp. 310–311).

To be sure, the other condition is of equal importance, since even under conditions of oversupply, competition is possible only if the producers themselves, by changing quality and/or prices, are able to influence the criterion of selection which is the basis of losing. For competition through price or quality, see *Abbott* [1], especially pp. 110–123 and 171–190, and Stigler [25].

We assume that the supplier is characterized by the typical traits of a resource-constrained firm. That is, we assume that its supply is inelastic. This means that the firm will not increase its supply in the case of higher than the prevailing prices, or it will not increase it considerably, or even if it does increase it, it will not be done so as to match the structure of demand.*

The seller does not initiate corruption but does not resist it either (we make no assumptions about his official salary). If no buyer corrupts him, he gives everyone official quality for the fixed price. If corrupted, however, he is willing to offer better than average quality. The seller uses up all the inputs available for the production of the good (sells them to the buyers), he himself does not appropriate or use any of them.** Also, he gets all the necessary inputs through official channels. He does not buy inputs in the free market so as to sell the produced goods for his own profit. The seller withdraws inputs from non-bribers and reallocates them so as to favour the bribers. To be sure, he withdraws only as much as is indispensable for satisfying the bribers as well as possible. This means that he tries to supply the bribers with a quality that corresponds to the corruption price (official price plus corruption overcharge)*** and only to this extent does he decrease the quality of goods sold to non-bribers.

We assume that demand is inelastic within a given price range (p, p'), i.e. the given good—either because of its great importance or because of vested interests in its production—cannot be substituted by any other good.[+]

Furthermore we assume that the price of the good (both the official price and the corruption price) is below the ceiling that any buyer is willing to pay as a maximum for the given good.

The buyers' preferences are uniform and constant over time. We regard them as

* Because, among other things, its output plan, or the composition of its output is independent of its costs or the volume of its potential returns (i.e. the relative prices). Rather, it depends on whether it is able to secure the necessary inputs for its output plan in the desired quantity and at the desired time. Often this is not the case. Or even if it is, often the available inputs do not make the desired outputs possible. Behind the assumption of inelastic supply we find the basic structural traits of a shortage economy. As to the notion of resource-contrained firm see: *Kornai* [14].

** Here, as in the following, we make the strictest possible assumptions about the non systems-specific conditions of our model. If our conclusions hold water under such conditions, they will be *a fortiori* valid under less strict (more "realistic") circumstances. This method enables us to find the sufficient conditions of corruption which means offering a valid causal explanation. We shall deal with this problem when formulating our conclusions.

*** Out of the possible rational options this is the least favourable from the point of view of the seller, and the most favourable from that of the buyer (for this see the argument in the previous footnote)

[+] The assumption of inelastic demand in a given price range (p, p') for a number of important goods and services seems to be empirically valid. Medical care, because of its great importance, is, to a certain extent, such a good, or repair and maintenance of cars and other durable goods or of houses, owing to vested interests in consequence of the major investments in them; or some construction goods, etc.

autonomous preferences, i.e. we assume that they cannot be manipulated and are not prone to adaptive preference formation.*

Lastly, our buyers know precisely the quality of the purchased good, and the standard relationship between price and quality. In this respect they are as well informed as the seller.

With the help of our model we analyze the spread of corruption. We say that corruption is spreading in the market of the given good if at least one more buyer chooses to pay a bribe as compared to a previous situation (point of time). Our buyers calculate rationally, in their choices they weight both the price and the quality of the product. Out of the feasible options they will choose the one in which their net individual utility (return minus costs) is maximum. (We assume that utility is in a linear relationship to changes in price and quality: e.g. one unit decrease in quality implies one unit decrease in utility.) To be sure, they attempt to obtain a good that satisfies their demand. In their choices they first of all weight the net utility, but given identical net utilities, will choose the better quality.

Let us reformulate the above. If the buyers purchase the good without paying bribes the official price of the good (p) and its actual quality equals its official quality (q_{off}), i.e. everyone gets the value he paid for. In this case the net utility ($q_{off}-p$) of buyers will be zero. If they wish to get better quality (q_c) and they pay a bribe (Δp) in order to obtain it, the seller will attempt to supply corresponding quality ($q_c=p_c$) for the corruption price ($p_c=p+\Delta p$). This surplus of quality, more precisely the necessary inputs are transferred by the seller and are withdrawn from non-bribers. Thus, if there are bribers, then the non-bribers get worse than official quality ($q<q_{off}=p$) for the official price (p). However, the quality sold to non-bribers cannot deteriorate below a certain critical (minimum) level (q_m). No buyer will accept the good whose quality is below this level. We assume for simplicity's sake that the amount of bribe is constant: bribers always pay the same amount. The seller supplies q_c quality to every single briber and q quality to every single non-briber at every single purchase event.

In the beginning, there is no bribe payer in the market. Buyers have no experience in obtaining the desired quality by paying a bribe. Let us assume, however, that there exists one buyer who decides to get the sought-for quality through

* We face adaptive preferences in situations when individuals regard the narrowing of the feasible set or the unrealisability of favourable alternatives not only as negative changes which limit their decisions but also adjust their preferences accordingly. As a consequence, they unconsciously lower their expectations, i.e. they will be satisfied even when they have every reason not to be. It can be proved that the process of spreading corruption implies adaptive preferences of buyers which further aggravates the already existing negative consequences of corruption. However important these secondary consequences, we are unable to deal with them, or to prove the above statement within the scope of this study. For adaptive preference formation, see *Chapter III* of *Elster* [7] where the author gives a detailed analysis of the logic of this mechanism of perverse preference formation and shows how it works in various situations—in everyday life, in economy or politics. He deals with the destructive consequences of what may be called "sour grapes" or "we must like what we have" type situations.

corruption. His net utility will be the same as if he had not paid a bribe but he obtains the quality that is up to his standards.*

After having listed the assumptions, let us formulate one of our central propositions. If there is at least one buyer who chooses to pay a bribe in order to obtain better quality in a corruption-free market which is in equilibrium in terms of quantity and where *de facto* inhomogeneous quality is offered at an officially fixed price, in most cases a number of buyers (in certain cases: all of them), on the basis of their expectations concerning net utility, will pay bribes. This process leads to an absurd outcome: bribers will be worse off than in a corruption-free situation (as regards their individual net utility) and the quality of the good obtained through corruption will not be (or only slightly) superior to the one that was available to anyone in the pre-corruption case.

The outcome of the spreading of corruption are shown in *Figure 1.*** Let us look at section (*a*) of *Figure 1*. On the horizontal axis the proportion of bribers is measured. Since the total number of buyers is constant all along, the proportion of non-bribers is easy to calculate. Between 0 and 1 on the horizontal axis not only the proportion of bribers increases but so does the experience of buyers (both corrupting and non-corrupting). They have made several purchases of the good. At point n_0, for instance, all buyers have made exactly n_0 number of purchases—those who paid p_c price obtained q_c quality while those who paid p price only got q quality. The variations in quality are presented on the vertical axis. The spreading of corruption is shown in a continuous model by a linear curve. At every point there is a unit increase in the proportion of bribers; in other words, at every point an additional buyer decides to pay a bribe. This means that we regard the flow of information and the accumulation of experiences concerning the possibilities and advantages of corruption as linear.*** Parallel to the increase of the number of purchases there is an increase in the experience about the advantages of corruption. More and more buyers sense that it is probably worthwile to pay a corruption overcharge. This way, their net utility is higher than it would be without corrupting.

To every possible proportion of bribers (to every point on the horizontal axis) there belongs a quality obtained by bribers and non-bribers, respectively, and also an

* Or reformulating it: since $u_c = \varphi(n=\varepsilon) = q_c - p_c = f_c(n=\varepsilon) - p_c = 0$. (Where $\varepsilon > 0$, $\varepsilon \to 0$) and $u = \varphi(n=0) = q - p = f(n=0) - p = 0$, therefore $\varphi_c(n=\varepsilon) = \varphi(n=0)$. The choice of the briber is thus based on $f_c(n=\varepsilon) > f(n=0)$. See footnote ** on page 385.

** Our model belongs to the family of Schelling-type models of binary choices involving externalities. Both in building the model and in its graphic representation we followed *Schelling* (see [22] pp. 213–243.)

*** In reality this is usually a cumulative process which follows the principle of critical mass. After having reached a critical point, the spread of experience accelerates and as a result, corruption spreads not at a uniform but at an increasing rate which further aggravates the already existing negative consequences. For the principle of critical mass see Schelling [22], pp. 91–110 and *Granovetter* [10], more recently *Oliver* et al. [17].

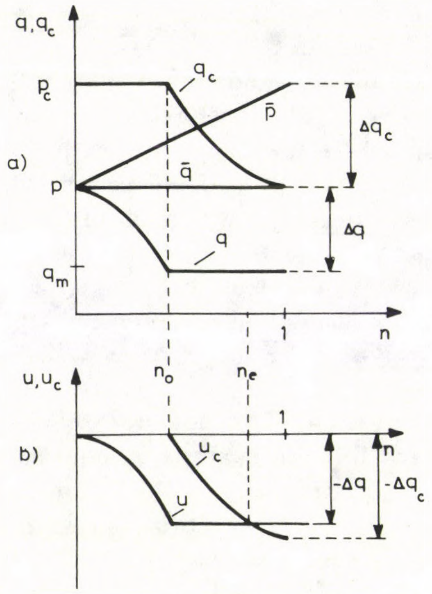

Fig. 1
Quality and individual net utility as a function of the spread of bribery

n	=	proportion of bribers $(0<n\leq 1)$,
p	=	official price
Δp	=	corruption overcharge (bribe),
p_c	=	corruption price $(p_c=p+\Delta p)$,
$\bar{p}$	=	average price,
q	=	quality obtainable by non-bribers $(q=f(n))$,
q_c	=	quality obtainable by bribers $(q_c=f_c(n))$,
$\bar{q}$	=	average quality,
q_m	=	acceptable worst quality,
u	=	net individual utility of non-bribers $(u=\varphi(n)=(f(n)-p)$.
u_c	=	net individual utility of bribers $(u_c=\varphi_c(n)=f_c(n)-p_c)$,
Δq	=	level of tolerance of non-bribers $(\Delta q=\lvert q_m-p\rvert)$,
Δq_c	=	aspiration level of bribers $(\Delta q_c=p_c-p)$,
n_0	=	point of optimum (Pareto-optimum) $(n_0=\Delta q/(\Delta q+\Delta q_c)$.
n_e	=	equilibrium point $(n_e=\Delta q/\Delta q_c)$.

average quality and average price. p_c and p are prices paid by bribers and non-bribers, respectively, q_c and q stand for the quality of the good.

The official price (p), the corruption price (p_c) and the acceptable worst quality (q_m) of the good are constant ($p_c > p > q_m$). The average quality of the good is constant over time* ($\bar{q} = p$), its average price ($\bar{p}$) increases with the increase in the proportion of bribers.

Two curves deserve special attention: The ones representing the quality of goods sold to bribers and non-bribers, respectively ($q_c = f_c(n)$ and $q = f(n)$). The seller tries to supply a quality corresponding to the corruption price ($q_c = p_c$) to every briber as long as is possible, and this can be achieved by decreasing the quality sold to non-bribers. This attempt is unhindered up to a certain proportion of bribe payers (this point is marked n_0 on the horizontal axis). As long as the quality sold to non-bribers can be further decreased (this is possible up to point q_m), inputs can be transferred in order to increase the quality of the product sold to bribers. If, however, the proportion of bribe payers surpasses n_0, the seller becomes unable to "save" further inputs at the expense of non-bribers. Therefore, the greater the proportion of bribers beyond n_0, the lower the quality obtained by them.**

Point n_0, therefore, indicates the maximal proportion of bribers; at this point they all get a quality corresponding to the corruption price ($q_c = p_c$). If at point n_0 one single additional buyer chooses to pay the corruption price, every briber will be worse off than they were at n_0. n_0, therefore, is the optimal point in the spreading of corruption (Pareto-optimum) for the given set of bribers both actual and potential.

* The $\bar{q} = p$ relation is easy to check, if we substitute the formulae of functions q_c and q into the formula: $\bar{q} = nq_c + (1-n) \cdot q$ (see the next footnote).

** The quality function of the good obtained by bribers ($q_c = f_c(n)$) and the one obtained by non-bribers ($q = f(n)$) looks as follows. In the interval $n \leq n_0$ the bribers' demand for surplus input is $n(p_c - p)$. This quantity can only be saved at the expense of non-bribers. In accordance with our previous assumption, it is spread out equally, thus the good purchased by non-bribers contains by $[(n(p_c - p)/(1-n)]$ less input than the official quality. The quality of their goods in the interval $n < n_0$ is: $q = f(n < n_0) = p - [n(p_c - p)]/(1-n) = (p - np_c)/(1-n)$. Bribers get a quality which corresponds to the corruption price up to point n_0 ($n \leq n_0$). So: $q_c = f_c(n \leq n_0) = p_c$. At point n_o, however, the seller comes up to constraints; since he has reached the still acceptable level of quality deterioration (q_m), he cannot further decrease the quality sold to non-bribers. That is: $(p - n_o p_c)/(1 - n_o) = q_m$; and therefore $n_o = (p - q_m)/(p_c - q_m)$. Thus in the interval $n > n_o$ the seller has to decrease the quality sold to bribers as well. He would have to save $n(p_c - p)$ quantity on non-bribers but because of the quality constraint q_m he is able to save only $(1-n) \cdot (p - q_m)$. He is short of $n(p_c - p) - [(1-n) \cdot (p - q_m)]$ quantity. If he spreads this out equally on bribers, then the quality they get will be: $q_c = f_c(n > n_o) = p_c - [n \cdot (p_c - p) - (1-n) \cdot p - q_m)]/n = q_m + (p - q_m)/n$. Point n_o, and the function q and q_c will be as follows:

$$q = \begin{cases} (p - np_c)/(1-n), & \text{if } n < n_o \\ q_m \quad , & \text{if } n \geq n_o \end{cases}$$

$$q_c = \begin{cases} p_c \quad , & \text{if } n \leq n_o \\ q_m + (p - q_m)/n, & \text{if } n > n_o \end{cases}$$

$$n_o = (p - q_m)/(p_c - q_m).$$

When the proportion of bribers is smaller than or equal to n_0, individually they all are in equilibrium. Thus, it holds for every single bribe payer that his net utility is: $u_c = \varphi(n < n_0) = q_c - p_c = 0$ (see section (*b*) of *Figure 1*). At the same time, up to this point non-bribers get worse and worse quality (q) for the official price (p). At n_0 they get only q_m quality. Their net utility is negative all along ($u = \varphi(n) = q - p$) and parallel with the spreading of corruption it decreases to $(q_m - p)$ (see section (*b*) of *Figure 1*).

The location of point n_0 is a function of the aspiration level of bribers on the one hand and of the level of tolerance of non-bribers on the other. In other words, it depends on how much better than official (average) quality ($q_{off} = \bar{q} = p$) the bribers aspire for on the one hand and how low a quality the non-bribers put up with on the other. This relationship looks as follows: $n_0 = \Delta q/(\Delta q + \Delta q_c)$, where Δq is the difference between the tolerated lowest quality and the (official) average ($\Delta q = |q_m - p|$); Δq_c is the difference between highest quality aspired for and the average ($\Delta q_c = p_c - p$).*

If bribers are satisfied with slightly higher than average quality and/or non-bribers tolerate much lower than average quality the value of n_0 will be higher, in the opposite case, it will be lower. Wherever n_0 is located, it is clear that if the proportion of bribers does not exceed this point, they will be better off, their net utility will be higher than that of buyers who pay the official price. The situation is not as clear-cut as this when corruption spreads beyond this point. *But does it go beyond it at all?* Are those who refrained from corruption till n_0 sufficiently motivated to join the "club", thereby causing the process to exceed n_0? The answer is yes. In the following we will prove that whatever the actual value of p, p_c and q_m (with of course $p_c > p > q_m$), corruption never ceases to spread, never stays at n_0 point of optimum, it always exceeds it. In other words, assuming rational (utility maximizing) buyers, the above described absurd outcome emerges: bribers end up being worse off than they had been in the beginning of the process (their net utility will be negative), the quality of the good they obtain will decrease. In certain cases it will decline to the level of the official quality or even below it.

We shall prove this in two steps. 1. We define an n_e equilibrium point, where $\varphi_c(n_e) = \varphi(n_e)$, i.e. the utility from corruption equals the utility of non-corruption. Since in the interval $n > n_0$, u_c monotonously decreases and u is a constant function**, it

* This relationship is easy to prove by identical transformations. Since $\Delta q = |q_m - p|$, $\Delta q_c = p_c - p$, and $n_o = (p - q_m)/(p_c - q_m)$, therefore $n_o = (p - q_m)/(p_c - p + p - q_m) = \Delta q/(\Delta q_c + \Delta q)$. Since $\bar{q} = q_{off} = p$, this relation can be formulated both for official (q_{off}) and for average ($\bar{q}$) quality.

** Using the formulae of footnote on page 381 the function $u_c = \varphi_c(n) = f_c(n) - p_c$, and $u = \varphi(n) = f(n) - p$ are the following:

$$u = \begin{cases} -[n/(1-n)] \cdot (p_c - p)\,, & \text{if } n < n_o \\ q_m - p\,, & \text{if } n \geq n_o \end{cases}$$

$$u_c = \begin{cases} 0\,, & \text{if } n \leq n_o \\ q_m + [(p - q_m)/n] - p_c\,, & \text{if } n > n_o \end{cases}$$

is certain than in the interval $n > n_e$ the relation gets reversed, i.e. it will be individually more rational for buyers (will yield them higher relative utility) to refrain from corruption than to join in (see section (*b*) of *Figure 1*). Thus n_e is the equilibrium point of the process. At this point the corruption process comes to a halt. 2. We shall prove that $n_e > n_0$, i.e. the process comes to an end *beyond the* n_0 *optimal point;* that is, it is always supraoptimal as regards the number of bribers, and always suboptimal as regards the marketed quality.

1. Since $\varphi_c(n_e) = \varphi(n_e)$. That is: $q_m + [(p - q_m)/n_e] - p_c = q_m - p$. Therefore: $n_e = (p - q_m)/(p_c - p)$. We know from before* that $n_0 = (p - q_m)/(p_c - q_m)$. 2. We wish to prove that: $n_e > n_0$. In other words: $(p - q_m)/(p_c - p) > (p - q_m)/(p_c - q_m)$. After the appropriate transformation this can be reduced to the inequality $p > q_m$ which is true by definition, therefore $n_e > n_0$ is always true.

We have seen that the corruption process always exceeds its optimum (from the viewpoint of bribers both actual and potential). Can it spread so as to include *all* buyers? It is easy to prove that, as in the case of n_0, the location of n_e is also a function of the aspiration level of bribers (Δq_c) on the one hand, and of the level of tolerance of non-bribers (Δq) on the other, in the following way: $n_e = \Delta q / \Delta q_c$.** As is clear from the transformed equation, there are three typical outcomes of the corruption process represented by our model see *Figure 2*).***

In the case *A* ($\Delta q_c > \Delta q$) it is either that bribers raise the price too high as compared to the level of tolerance of non-bribers because they wish to obtain much higher quality than the official one, or that non-bribers are unwilling to put up with much lower quality than the official one. The equilibrium point will be $n_e < 1$, i.e. the market will be segmented into a corrupting (n_e) and a non-corrupting ($1 - n_e$) part. At n_e the quality obtained by bribe payers will be (q^*), lower than the *fair* one ($q^* < q_c = f_c(n \in H)$, where $u_c = \varphi_c(n \in H) = 0$) or the *optimal* $q^* < q_c = f_c(n \leq n_0)$, nonetheless, it will be somewhat higher than the original $q_{off} = \bar{q} = p$ quality ($p^* > p$).+

In the case *B* the aspiration level of bribers equals the level of tolerance of non-bribers ($\Delta q_c = \Delta q$). In such cases all buyers opt for corruption. As a consequence, in spite of paying corruption overcharge, everyone will get the same quality at point $n_e = 1$ as they did in a corruption-free situation ($n = 0$), when no one paid bribes ($q^* = p$).

In the case *C*, when the aspiration level of bribers is below the level of tolerance of non-bribers ($\Delta q_c < \Delta q$), the process again is extended to every buyer. In this case

* See footnote on page 381.

** $n_e = (p - q_m)/(p_c - p) = \Delta q / \Delta q_c$, since $\Delta q = |q_m - p|$ and $\Delta q_c = p_c - p$.

*** The figure was drawn by fixing p and q_m (i.e. Δq) and changing p_c. To be sure, there could be cases where p and p_c (i.e. Δq_c) are fixed and q_m is changing. However, all possible cases can be reduced to the solution presented above, therefore our conclusions are not influenced by this technical simplification.

+ This can be proved as follows: $q^* = f_c(n_e) = q_m + (p - q_m)/n_e = q_m + (p - q_m)/[(p - q_m)/(p_c - p)] = (p_c - p) = q_m + \Delta q_c = q_m + \Delta q + \Delta q_c - \Delta q$. Thus $q^* = p + (\Delta q_c - \Delta q)$. Since in the case *A* $\Delta q_c > \Delta q$, therefore $q^* > p$.

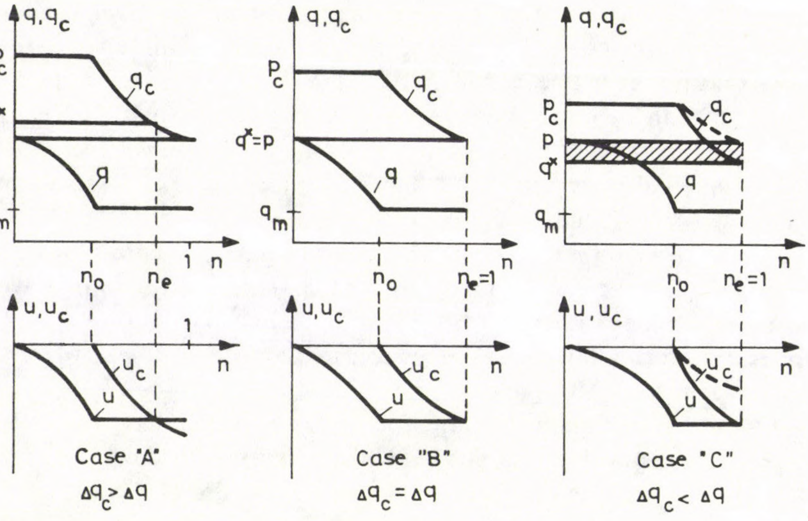

Fig. 2

The three possible outcomes of the spreading of the corruption

$\Delta q_c = p_c - p$, the aspiration level of bribers,

$\Delta q = |q_m - p|$, the level of tolerance of non-bribers.

$n_e > 1$ which is meaningless in terms of mathematics, since the proportion of bribers cannot exceed 100 per cent. Therefore $n_e = 1$. In this case, additional possibilities for profit-making open up for the seller (see the lined area whose size is: $n_e \cdot (p - q^*) = p - q^*$). If he makes use of them*, the buyers will be worse off than in the beginning not only as far as utility is concerned, but they also get lower quality than they did in a corruption-free situation. The market as a whole may deteriorate even in terms of quality $(q^* < p)$.

* To be sure, this contradicts our assumption that the seller does not consume or withdraw inputs. However, his input withdrawal in the case *C* is not an exogenous assumption, rather, it is an endogenous characteristic of such cases. That is: the given situation is not the consequence of input withdrawal, rather, the seller may withdraw inputs from the market precisely because of the specific characteristics (independent parameters) of the situation. Under such conditions, even within the original constraints of our model, it would be irrational on his part not to make use of this opportunity. Empirically this may take the following forms: 1. he or his family consumes the given product (in the case of services this may result in increased leisure time) and/or 2. he sells the product for money outside the market (in the case of services this is usually impossible; and not very reasonable in the case of products since the price-level is the highest in the market of the given good and so is the risk of being caught) and/or 3. he provides free goods or services to his clients for similar services in return.

Conclusion

Our model may well be extended so as to cover cases when the aim of corruption is *a)* to shorten or eliminate waiting resulting from shortages: or *b)* to improve buyers' chances of obtaining better quality out of heterogeneous stocks sold at uniform prices.*

The mechanisms described in our model seem to prevail in the market of a number of important goods and services which have a great impact on our living standards. In every case when the conditions of market competition are lacking and, at the same time, the seller is able to influence the quality of goods and services (whether it is attention, care, time or physical inputs used in the production of goods) or the chances of obtaining higher quality when the quality of uniformly priced goods or services is not uniform, or the seller is able to shorten the waiting time in the case of shortage—in all these cases it is highly probable that the processes described in our model will emerge. Once the custom of giving tips, bribes, "thank you money" has, for some reason,** become part of the structure of a given community, it will, for purely rational reasons, affect the community as a whole. And while it includes an increasing part of the market, the selective advantages attainable through it unavoidably disappear into thin air. In some cases this mechanism leads to the total demoralization of certain markets: the absolute deterioration of the quality of goods and services or the absolute increase of waiting time.

There are several examples of transferring *physical inputs:* weak coffee, small portions in restaurants, mixing water in wine, etc. Similar examples can be cited from other areas: often it depends on the benevolence of the seller how much coal-dust there is among the coal or how many bricks are broken in the load, or what is the proportion of defective goods. The most expressive examples of bribing someone into paying more *attention (care) and/or time* are found in health care. The fact that it is up to the doctor how often he sees the patient, how much time and attention he spends on his treatment, prompt many patients to pay "than you money" in order to get more time and attention or to avoid getting less, for other patients do the same.*** We may mention here the repair services of durables (from TV-sets to automobiles) and also the repair and maintenance services in construction industry. In all these cases the person who supplies these services treats his time and attention as a scarce resource and, if bribed,

* We deal with corruption games which are played for the shortening of waiting time in the Hungarian version of this paper (see Galasi–Kertesi [9]).

** This is in accordance with our assumption that the process of corruption is triggered by some external factor. This may easily come about since a pre-corruption situation may be transformed into corruption by the slightest force—even by the decision of one single buyer. Models of this type are called "tipping point" models in the literature. See, e.g. Schelling's models on residential segregation [20], [21].

*** Medical care is provided in Hungary free for every citizen of the country. So, *in principle* everybody may consume the same amount of medical services.

he can easily transfer his resources. We cannot disregard those well-known situations when we load lawyers, kindergarten teachers, nurses with visible signs of our gratitude so as to secure attention, care, professional diligence for ourselves and our families. Clearly, these are also matters of "transferring" scarce resources (time and attention). Examples of the "transfer" of *physical inputs as well as time* and attention can also be drawn from the health care system: a dentist is able to influence both the attention given to a patient and the quantity and quality of materials used in the treatment.*

Theoretically, there is no technical obstacle in the way of influencing the *waiting time* (time spent in queuing). It may take place every time when the supply of certain goods or services is done by rationing, portioning. Typical examples are the waiting lists for telephones, cars, hospital treatment or the time spent in the waiting rooms of doctors or in a garage. We may cite examples of sellers who earn extra income by supplying *better quality out of a heterogeneous stock sold at a uniform price,* whether it is goods or services. For instance: it does matter how many beds are in the hospital ward we are placed in; whether the building materials we buy are properly stored and therefore better preserved; whether a used car we buy from a firm is in good condition; whether a durable goods is reliable; whether the theater or concert ticket we buy is for a good seat;** whether the new car we buy is of the desired colour.

There is no need to cite further examples. Our model, despite its simplicity, seems to describe well the particular logic of the spread of corruption stemming from rational individual motives. Moreover, it may well be that through the very simplifications themselves the essential characteristics of this process come into light; namely, when we constructed our model we made a number of not at all insignificant simplifications—or "unrealistic" assumptions. 1. We assumed that the seller is a passive participant of the corruption process: that he does not press for bribes; that he himself does not steal or sell illegally. 2. We ignored the official income level of the

* The examples given here imply so-called "credence goods" whose quality can be established only *ex post* and even then with considerable *uncertainty* (*Darby–Karni* [6]). These are goods that have the highest cost of acquiring information about. It is no coincidence that in the case of credence goods the seller has an advantage over the buyer as far as information is concerned. Under such circumstances theory usually predicts the failure of competition, more precisely it predicts the inability of market mechanism to secure optimal supply. In the context of a market situation, however, there exist several basic institutions or mechanisms which are able, if not to eliminate, to lessen the extent of this problem of suboptimality (see *Akerlof* [3]). Under conditions of informational asymmetry between buyer and seller, the institution of corruption produces these problems of suboptimality just like the market, only, due to its illegality and uninstitutional character, it *lacks* those balancing mechanisms which, in a market situation, may, to some extent, neutralize the negative consequence of asymmetry. Within the scope of this paper we cannot deal with these very significant secondary consequences.

** According to *Alchian* and *Allen* ([4], pp. 162–163) it is by no means an accident that the good seats for popular programs organized by non-profit institutions are not much more expensive than the not so good ones. The excess demand for good seats makes it possible for the organizers to do an inexpensive favour—of course not completely in an unselfish manner—to some of the aspiring guests.

seller, i.e. the circumstances that may motivate him to press for bribes. 3. We treated bribes as uniform and constant over time, although it is highly probable that they increase with repetition. 4. We disregarded the consequences of existing income differences among buyers, i.e. that in connection with or independent of it they may bid so as to raise the price at the expense of all. 5. We did not calculate the consequences of bidding for the standard of living or for other markets. 6. We described the learning process which accompanies the spreading of corruption as linear, although in all probability it is a strongly cumulative process in its critical phase. 7. We ignored the severe consequences of informational asymmetry between buyer and seller, i.e. we disregarded those additional opportunities for profit making that come from the fact that buyer usually have highly inexact information about quality and price in corrupted markets. 8. We assumed that buyers have autonomous preferences, although from their special position adaptive preferences are more likely to follow.

By adopting these clearly unrealistic constraints we have set out to prove that the *conditions* we excluded are *not necessary* for the spreading of corruption. The well-known outcomes occur even if we exclude the above listed more realistic conditions from our model. Within more realistic conditions the consequences of corruption will be even worse than in our model. This method enables us to ignore the only seemingly necessary conditions as well as to find the *sufficient* ones. The latter are included in the substantive conditions about market characteristics. In them the major institutional trait of a shortage economy is reflected: *the structural inelasticity of supply and in this context the ineffectivity of prices.*

This market characteristics is built into our model through the fixed quantity of supply. At the given—official—price level a greater quantity or a very different selection of the given good could be sold. However, the supply does not react to signs from the demand side: in the case of waiting the quantity, in the case of corruption for better quality the selection does not change. *This inflexibility is the root of corruption.*

The fact that through paying bribes—more precisely: through the repeated process of corruption—sooner or later the market will be in equilibrium, gives rise to the illusion that an increase in official prices would be the appropriate method of fighting corruption. The relation between supply elasticity (inelasticity) and equilibrium (non-equilibrium) prices is not symmetrical, however. As long as elastic supply implies the possibility of equilibrium prices, creating temporary equilibrium by way of price increase without also creating elastic supply, it only means that we pay more for the same amount. Price increases in themselves, neither official, nor illegal ones (corruption) are sufficient to create elastic supply, they only reproduce corruption at a higher price level.

The solution to the problem lies in the creation of flexibility of supply. This is the conclusion we reached with the help of our model. We do not think it is our task to prove that the majority of Hungarian firms and non-profit institutions are characterized by inelastic supply. The literature* supplies us with dozens of convincing theoretical and empirical arguments. We, on our part, are satisfied with describing the consequences of this enterprise behaviour in relation to corruption, or with tracing back corruption to the obstinate phenomenon of planned economies: to the structural rigidity of supply.

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* See Kornai [14], *Soós* [23], [24], *Szabó* [26]. We would like to mention that the (structural) inelasticity of supply is not a homogeneous notion but a collective one comprising different phenomena, although their impact on the shape of the aggregate supply curve is similar. Without trying to be comprehensive, we shall name some empirically important cases:

1. For several reasons mobilizable slacks are present only to a small extent in the economy ([14], pp. 33–35, 47, 103) therefore a price increase cannot be very well followed by a better utilization of already *existing capacities* and thus an expansion of supply without investments. Basically this explains the *short-run* inelasticity of the supply curve.

2. At the same time the price rise does not necessarily go together with building up *new capacities* either; more precisely: the creation of new capacities is quite independent of price changes (this is the basic cause of the *long-run* inelasticity of supply). The long-run inelasticity of the supply curve is caused by the following facors:

a) the owners of capital are in most part institutions whose decisions are not or not primarily influenced by profit expectations, rather, they are motivated by the need to meet demands (to improve the "supply situation"; to lessen severe shortages; to substitute import; to increase export revenues).

b) owners of capital—mostly private—who are interested in the amount of expected profit would be theoretically motivated to enter the market by an increase in prices, only their enthousiasm to invest is considerably cooled by the large number of central regulations and limitations and by the primitive business infrastructure (practical difficulties in borrowing funds, lack of market instruments and transparence, etc.).

c) finally if the private capital owners do enter the market, it is highly probable that they will choose goods, production technology or market segment which, despite the higher price, do not result in significantly more or better quality goods for the buyers. (See our paper about the "perverse competition" between the first and second economy [8]).

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ЯВЛЕНИИ КОРРУПЦИИ В ЭКОНОМИКЕ С ЦЕНТРАЛЬНЫМ ПЛАНИРОВАНИЕМ

П. ГАЛАШИ–Г. КЕРТЕШИ

В своей статье авторы рассматривают механизм, приводящий к возникновению явлений коррупции в социалистической экономике, а также то, как сказывается это на положении покупателей, как тех, кто готов пойти на дополнительные расходы с целью приобретения различных благ, так и тех, кто отказывается делать это. Проблема исследуется с помощью простой микроэкономической модели. Показывается, что явление коррупции возникает и в том случае, когда хорошо информированные о состоянии рынка покупатели исходят из соображений наибольшей рациональности и максимальной выгоды, а в своей массе честных продавцов можно соблазить взяткой. В этом случае рано или поздно значительная часть, а в определенной ситуации и все покупатели предпочтут пойти на дополнительные расходы для того, чтобы избежать длительных поисков товара или получить товар лучшего качества. Однако в определенный момент не только те покупатели, которые не могут или не хотят идти на это, но и те, кто пользуется такой возможностью, окажутся в худшем положении, чем если бы рынок был свободен от этого явления. Однако, несмотря на это, коррупция будет усиливаться.

В заключение авторы называют некоторые важные с практической точки зрения товары, на рынке которых описанный с помощью модели механизм приводит к возникновению коррупции. Авторы делают вывод, что наиболее важная причина распространения коррупции — (структурно) негибкое предложение как специфическая особенность социалистической экономики.

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REVIEWS

REPORT ON THE PROJECT "SCIENTIFIC FOUNDATIONS OF THE FURTHER DEVELOPMENT OF ECONOMIC POLICY"*

R. NYERS–G. RÉVÉSZ–A. SIPOS

This project, focused on Hungary, was intended to contribute to the proper formulation of the economic policy targets, and to the determination of its related instruments, by presenting the economic-political context that determines economic development. With various degrees of elaborateness conforming to the nature of the different fields, the following subject-matters have been given particular attention:

– Questions of transition to the intensive path of development;

– Development of economic control and management, and the organizational system;

– Industrial policy in the period of intensive development;

– Agricultural policy and food economy.**

– Standard-of-living policy under changed economic conditions;

– International economic integration.

Here-under the most important statements of the research works are set forth.

Economic control and management based on plan directives, and the survival of certain elements of forced industrialization are, after the first phase of structural transformation, *obstacles* in the way of evolving the motive powers of intensive development. Following elimination of the system of open plan directives (instructions), the previously developed economic conditions hinder the desirable way of development of commodity and monetary relations, lead to their deformation, and reproduce the hierarchical relationships between the superstructure and the economic organizations. The halt of the

*The project was included into the national long-term scientific research plan (OTTKT) covering the period from 1977 to 1985. It was the organic continuation of the research programme "Analysis of experiences of the Hungarian economic policy; suggestions for its further development" preferred on ministerial level, initiated and directed by the late István *Friss,* academician. Beside the basic institute of the research project, the Institute of Economics of the Hungarian Academy of Sciences, the following organs have also participated in the research and its organization: the Industrial Economic Research Team of the Hungarian Academy of Sciences, the Institute of Economic Planning of the National Planning Office and the International Economic Relations Secretariat of the Council of Ministers. Highly valuable analyses on economic policy matters have also been made in the Research Institute for Sociology of the Central Committee of the Hungarian Socialist Workers' Party, the Cooperative Research Institute, the Theoretical Research Institute of the Trade Unions, the Karl Marx University of Economics, a few supreme authorities and their research institutes. Some of the results of their analyses have been integrated into the activities of the major research project.

**The latter term includes in Hungarian terminology both agriculture and food processing – Ed. note.

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reform process in the early 1970s, and the low adaptability of the Hungarian economy are explained exactly by these factors. A hierarchical relationship between the economic control and management organs and the economic organizations is manifest in the complex system of expectations, bargaining about prices and regulators, excessive capital reallocation, and official measures going into details, often expressly of an individual character. The agreements of recent years, signed between control authorities and enterprises, initiated by the former with a view to increasing exports, are also reminiscent of the practice of plan directives. From the economic rationality aspect, all this has an adverse effect on economic policy as a whole, on the functioning of economic policy organs, and it also distorts enterprise efforts.

By the mid-1970s, the reserves and motive powers of economy to be found in additional resources, or in macrostructural changes had all become exhausted. Within the framework of the *accustomed* system of distribution and operation, all that can be done is retreat along with stagnating or even declining living standards. A drastic structural transformation and fast adaptation, the production of more upto-date and high-quality goods manufactured with the customers' needs may only be expected of a strong, steady, and up-dated continuation of the reform of the economic mechanism. This implies the necessity to develop a plan-influenced and self-regulatory market mechanism, autonomous enterprise functioning striving for increased assets, and intensification of the multisectoral nature of economy. An institutional system of rational financial management must be established which invests, upon market impulses, the bulk of its accumulated resources in accordance with profitability aspects. In addition, less efficient (loss-making) jobs, activities, and establishments must be abolished; this is a condition of a flexible functioning of the labour market.

As the reform process goes on, the economic control activities of the government organs ought to assume in fact a macroeconomic nature, aimed mainly at regulating the aggregate purchasing power, at developing the pulling sectors, and helping the sectors struggling with difficulties because of worsening conditions to solve their problems by market means. The economic leadership should promote the organization of foreign economic relations through central resources, and develop the productive and household infrastructure coordinated with needs, taking all possible effects into consideration. This shift of emphasis in economic control and management will necessarily entail economic, social and political tensions. These must be accepted as they come. It hinders the evolvement of a progressive reform process, if the political leadership, in its effort to ease the tensions in different fields, takes such individual measures as counteract the tendencies pushing for more efficient work, or if it tolerates that political and government organs, i.e. their officials infringe upon the independence of economic units, misinterpreting their own authority.

In Hungary of the early 1980s, economic and social troubles do not arise from the development of the commodity and monetary mechanism, but exactly from the underdeveloped and limited state of market functions. The analyses have shown these distortions. On the basis of experiences and scientific results so far achieved, the measures and conditions most needed for the development of socialist commodity and money relations, and a healthy economic growth based thereon can be outlined. On the other hand, the analyses also covered conflicts, the adverse impacts on the situation of certain groups of society, transitory employment troubles, the decrease in the real value of social benefits, etc. These are all to be taken into account in the process of the further development of the economic system and of the reform, and have to be efficiently handled by social policy.

Also, the economic policy and structural conditions of progress can be outlined, as well as the probable economic policy programme of an inevitable transitory consolidation phase.

Intensification of the adaptation processes requires greater freedom for price formation, which involves the risk of accelerated inflation. The rate of inflation must be regulated by means of adequate fiscal and monetary policies.

Having summarized the most important conclusions drawn in the field of subjects covered by the major research project, we shall point out a few further results achieved in the various research directions.

The research centred on the conditions and prospects of *economic growth* points out that the switch-over to intensive growth does not necessarily reduce the growth rate in the short run, either. The analysis has proved that a growing rate of investment does not automatically lead to accelerated economic growth. An investment rate higher than the investment absorptive capacity of the economy – depending also on the economic mechanism –, or an investment rate lower than that, will both lead to a decrease in efficiency, and are therefore a development-hindering factor. Relying on the analysis of the development conditions of Hungarian economy, the research has demonstrated in time that, under given conditions, foreign economic equilibrium must be considered as the primary constraint on growth, which in itself makes it inevitable to strongly reduce the growth rate as compared with earlier times, and demands the greatest care in laying down economic policy objectives aimed at acceleration. Therefore, continuous growth requires, in the first place, that the export potential of economy be strengthened, and not only in the field of production: it is perhaps even more important to rearrange the conditions of foreign trade activity, its organizational and functioning conditions.

Considerable progress has been made in exploring the preliminaries of the Hungarian reform of the *economic mechanism* and in revealing the main causes of the halt of the reform. It has been presented from various aspects that economic policy decisions and the functioning system of the economic mechanism are in close interaction. The given economic mechanism drives economic policy decisions onto a forced path and causes decisions to shift to a higher level of administration than would be necessary. Enterprise dependence on administrative bodies, and interventions made with reference to shortages on the domestic market and balance of payments difficulties maintain and reproduce individual central measures going into details. The corresponding attitudes and economic reactions of enterprises (managers) even further strengthen the necessity for intervention, without, however, producing any lasting results. Under such conditions, even the local trouble-shooting measures of party and state officials – directly facing the local and sectoral problems – may become the sources of further troubles.

It was an important lesson taught by the research works concerned with *industrial policy* that the development of industrial organization must be closely ingegrated into the system of objectives and instruments of industrial policy, and it should not be left to individual decisions fraught with permanent uncertainty, but should be promoted by indirect means based on market effects and enterprise initiatives.

The research works concerned with *agriculture* signalled in due time the probable changes (having taken place since then) in the system of conditions of the world market of foodstuffs. References were made to what could be done in the Hungarian foodprocessing industry to satisfy special demands and with a view to faster adaptation.

Analyses of the *living standards policy* promoted the development of a strategy apparently suitable for the handling of the slow-down and stagnation of development. Problems of the pension rules (retirement), as well as the situation of big families, raising several children, were covered. Proposals (partly accepted) were elaborated about the possibilities and forms of giving support to social groups in a handicapped social situation.

The analyses covering *foreign trade* and within it *CMEA relations* were mainly concerned with the actual functioning of the CMEA mechanism, and the prospects of further development. It has been pointed out that, for lack of business relations between enterprises, only partial results can be achieved in this field. Special emphasis has been given to the fact that the constraints of the international division of labour deriving from state relations prevent comparative advantages from being asserted, and cause a setback in the economic development of the individual countries as well as of the entire region. An extensive empirical examination of enterprises deeply involved in CMEA relations demonstrated the unfavourable effects exerted on the Hungarian enterprises in full detail. An analysis concerned with accession to the IMF was initiated within the framework of the major research project. This and the ensuing debate were one of the preliminaries of the official steps taken towards IMF membership.

Economic research and, within its scope, the results directly or indirectly attached to the major project contribute to the further development of economic policy. They have played an important role in the preparation and development of the economic policy turn of 1978–79, the economic policy measures taken so far in the 1980s, the party resolution on the situation and tasks of industry, and the party position taken in April, 1984.

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BOOK REVIEWS

SZABÓ, K.: *Arányosság és érték a modern gazdaságban* (Proportion and value in the modern economy). Akadémiai Kiadó, Budapest 1985. 482 p.

In economic theory, the *descriptive-explanatory* tendency has recently been growing in strength. This school of thought, also called *positive economic theory,* concentrates on what is there and not on what should be there. This is undeniably of great significance for assisting the practical implementation of an economic policy. At the same time, we are increasingly in want of an economic theory which studies the *development theory tendency.* In addition to analysing the current economic-technical conditions, these assign a role also to *prediction of changes.* This trend of research is certainly the more difficult one, and its direct applicability is also narrower. Yet it is indispensable for the further development of ideology.

In his new book, with a firm faith in the mission of science, Kálmán Szabó tackles the analysis of a topic of theory. It is a topic which is forever a subject of economics debates on the one hand, and the carrier of a huge number of new and unsolved problems of practical life on the other.

The category of *value* is not just an ideological divide within economic theory, but it is also a point at issue between different approaches within the same trend. The interpretation of even the classic Marxian theory lacks homogeneity, and the changed conditions of this century have led to a situation in which problems, believed to have been solved long ago, have reappeared as open issues. Through a long period, *proportion* was considered as the opposite of value in economic theory: as a consequence of an ideological interpretation of the planned economy, value and proportion were often, and by many, treated as mutually excluding categories. For practical purposes, however, such an approach proved to be useless. A *deliberate* assertion of proportion under *commodity relations* infers exactly the theoretical clarification of the *system of relations* between proportion and value. This is what Kálmán Szabó undertakes to do in his book.

The book has seven chapters, but its message is best traced along the "three main lines" which represent the basic structure of the book. They are as follows: 1. Criteria of the productive force of labour, value creation, and the transformation of value into price of production; 2. relationship of the value principle and the proportion principle; 3. questions of annuity formation and value distribution (redistribution).

In the first group of questions, the author clarifies a number of *basic contexts.* He starts by throwing light on the role of the *productive force dimension of labour:* productivity, intensity, complexity, and innovation (modernization through innovation) in value creation (reduction to value). Reduction of value means, in the author's interpretation, *reduction of separate actual labour to abstract labour which is socially recognized as necessary.*

Marxian economic theory has not yet integrated the *innovation problem* in its theoretical system. The book under analysis is thus a pioneering work in this respect. The author interprets innovation as *creation of novelty* in techniques, technology, and product, and the putting into practice and making use of the novelty as long as the given product or technology counts as novelty. In the course of making use of the innovation, however, the given product or technology gradually loses its novelty character.

Therefore, a chain of innovation activities has to be operated.

Modernization through innovation is a criterion of productive labour, which creates additional value, and constitutes the so-called *innovation value.* The concept of the innovation value – related to but not identical with the additional value created by more complex labour – is a help in analysing questions of economics such as international terms of trade, changing rates of additional value, the non-inflationary quotient of price increases, etc.

It is to the book's credit that it examines the reduction to value also on the assumption of a *diversified monopolistic enterprise structure* for, as often happens in economic studies, not all of the important characteristics of the modern enterprise structure (and of techno-structure) are taken into consideration. For example, reduction to value is strongly influenced by the *internal structure of large enterprises.* Namely, it is one thing if a monopolistic enterprise functions within a framework of subsidiary companies (divisional structure), and another if enterprise subsystems are connected through financial control, or proprietory function. The enterprise structure nowadays is complex because a considerable part of the small-producer (family) and small-capital sector is not functioning in a market of traditionally free competition, because they are satellite enterprises dependent on monopolies. The reason why all these considerations are necessary is that value is not a technical-economic category, but the expression of economic separation – and separation may be of widely different extent and intensity, according to the enterprise form.

The other large sphere of problems, constituting a major interest of the book, covers the *further development of the principle of proportion, and the historical examination of the relation between value and proportion.* What creates a relationship between the principle of value and that of proportion? The book provides a detailed and thoroughly well grounded answer to the question, which cannot be rendered comprehensively within the framework of a review. The principle of proportion is in fact the prevailing tendency of the quantitative and structural correspondence between production and effective needs.* Proportion is a *natural regulator* of the technical-economic division of labour, which is realized, under the conditions of commodity production, through the principle of value. The principle of value is the materialized abstract labour quantity regulating commodity production, the size of which develops in the course of the reduction to value.

Is there, however, no logical contradiction in that a *general (also naturally valid)* correspondence (proportion) is connected with a *particular* correspondence expressing the conditions of commodity production, i.e. value? The author provides a many-sided support for the intertwining of the two principles. One connecting element is that there is a technical-economic aspect not only to proportion, but to value as well. The technical-economic element of value consists in that *it is a determined quantity of labour without qualitative differentiation.*

In another approach, Kálmán Szabó deduces the intertwining of the two principles from the "chainlike" connectedness of need and value. Starting from value, the following question arises: what is it that determines the socially needed quantity of abstract labour? The answer: it is the distribution of the factors of production among different fields – which depends, in the final account, on the changes in needs.

Yet the strongest argument supporting the intertwining of proportion and value (their correspondence and their conflict) is found in the examination of the regulatory mechanisms of commodity production. Under the capitalist system of free competition, the prevailing tendency is that the abstract quantity of labour socially needed to produce the mass (and unit) of products corresponds, on a cyclical average, to the abstract quantity of labour needed to produce the mass (and unit) of value which satisfies effective needs.

In this form of the commodity production model, the principle of value plays a determinant role for proportion. That is to say, in this development phase, proportion as a *general* principle and value as a *particular* principle, together "obey" the *specific* principle of average profit.

*These comprise the sphere of needs determined by the given development level of the forces of production, the satisfaction of which practically assures smoothness for the reproduction process.

Much more intriguing are, however, the changes that take place in the relation between value and proportion on the influence of the forces and conditions of production of *monopoly capitalism.* In monopoly capitalism, there is a rapid progress in the forces of production, technical-economic relations, and the national and international socialization of labour.

As for socialization, first of all its *market effect* is to be noted: the classical market dwindles away, and imperfect competition becomes characteristic. The monopolistic-oligopolistic enterprise structure constrains the market in that "it changes the priority of its factors and, depending on the nature of the economic acts (development, business, etc.), it shifts the weight of the same factor to other positions." On the market, elements of income and supply gain importance as opposed to price and demand. In many cases, monopolies adjust themselves to market conditions not by means of prices, but of capacities and stocks.

Another consequence of socialization under monopolitistic conditions is that *the time horizon of development decisions is widened, whereas their spontaneity remains essentially the same.* Future needs (the future market) and the innovation development tendencies must be foreseen. Deliberation and organization on the enterprise level are made complete with *partial planning.* Under monopolistic conditions this, paradoxically, does not eliminate the *spontaneous tendencies.* That is to say, programmes may be fraught with grave mistakes; and the power relations of monopolistic associations change over time. What in fact happens in monopoly capitalism is that *the earlier spontaneous price regulation is replaced by the spontaneity latent in the strategic planning of monopolies.*

The socialization of the factors of production and labour causes changes in the relationship between value and proportion. What are they? First, *the field and scope of the basic relation of proportion expands.* Expansion in this field is related to the increased weight of the non-profit sector: that is the social, cultural, military, etc. objectives are not selected according to profitability considerations. The extension of the *time horizon* is due to the fact that in production as well as in the changes in needs, the developments of a more distant future must also be taken into account. Beyond the actual and potential factors of production, therefore, innovation potentials emerge in production; and in the field of needs, beyond effective and latent ones, virtual needs appear on the horizon. As the "third circle" – constituted by innovation potentials and virtual needs – presents numerous favourable possibilities (while also a number of risks for economic actors) the decision-makers are compelled to extend the perspective of their decisions.

Although the foregoing analyses are concerned with monopoly capitalism, they are not without interest for the further development of socialist economic mechanisms, either. This is because many similarities are found in the major trends of technical development and in the economic units of monopolistic position, that have developed in the course of the material-technical development.

The third "main line" of the book follows up the progress of rent formation and value redistribution.

a) Let us first see the questions concerning *rent formation* in the free competition model. The determination of the magnitude of social value on the basis of marginal inputs raises the question: ". . . how can differential rent contain a separate value, if the kinds of labour by which rent-producing property is produced have not any special characteristics in comparison with other activities? "

The routine answer to this question: the owners of the permanently limited factors of production distribute the value (surplus value) to the detriment of other sectors. Kálmán Szabó, however, arrives at a new conclusion. He says: if high tension prevails between permanently monopolized factors of production and expansive needs, declined need is not determined by the abstract quantity of labour needed on average for the production of a unit of product (in the author's special system of categories: nl II*), but by that needed for the production of a unit of the mass of use value (nl II) satisfying effective needs. This solution may dispel the terminological confusion surrounding market value, market production price, and their individual and social forms. (Marx and Ricardo apply 25 different terms for these phenomena).

*nl = socially necessary labour

Kálmán Szabó puts the rent problem in a new light from two aspects. First – which has already some preliminaries in scientific research – that rent may appear also in the manufacturing sphere, i.e. rent may be produced not only by natural factors of production, but also by monopolization of special means of production produced by labour, and of highly qualified labour. Second – and this is an important new result – that *a differential and an absolute rent based on innovation value* are assumed, and assigned an important role in the determination of the monopolistic production price.

Let us see the *absolute innovation rent* first. One of its conditions is the formation of an *additional part of value* which plays no role in the intersectoral compensation. This source of the absolute innovation rent is produced by the *improvement of labour,* in the course of modernization, through innovation. The other condition for realizing the innovation rent is the *monopoly of modernization through innovation,* which is, as a matter of fact, the exclusive ownership of scientific, control and organizational information and creative power.

Now let us go on to the *differential innovation rent.* Its source is the *false value* produced in the course of innovation. The condition of its formation is that *economic management monopoly may be extended also to modernization through innovation.* This is *related to the size of capital investment, the time factor of returns, and the complex inner structure of production.* As a result, *the innovation abilities of large enterprises are of different extent and quality, the life-span and circulation speed* of novelties are not identical, nor is the intensity of the need for them. In addition, innovation abilities are *permanently limited:* the innovation planned in a given field by one large enterprise is impossible (or very difficult) for the other large enterprise to adopt. In this, the author attributes a great role to the switch-over difficulties of the factors of production connected with the innovation.

b) Now let us turn our attention to the questions of *redistribution of (surplus) value,* since it plays an important role in developing the monopolistic price centre.

The total (global) profit of the multisectoral monopoly enterprises may be composed of the global average profit, natural and innovation rents, and parts pumped over (redistributed) from values produced elsewhere. The author breaks with the conception in which monopolistic profit is *basically* derived from the non-monopolized sphere. The inequality between monopolies (difference in vigour) accompanied by the *permanently limited* material and intellectual *factors and/or their exclusive possession, lead to the redistribution of profits also among monopolies.* This is to say that the monopoly enterprises work with permanently different aggregate (global) rates of profit.

As regards profit rates by products (partial profit rates), they are *dominated by* the total (global) profit rates of enterprises. In relation to the classical production price, therefore, the distributive process of the surplus value is changed. If, for example, a sector of low organizational composition forms part of a production structure based on large enterprises, of which the sectors of high organizational composition are in a favourable position of profitability, the pumping-over within the enterprise (but between sectors) may take place also from the latter sectors to the former.

In monopoly capitalism, *the relative prices of* equilibrium of the reproduction cycle cannot be determined by the social production prices of the specific goods containing the average profit rate. The principle of value, intertwined with the principle of proportion, is further modified and finds expression in the *monopoly-capitalist production price aggregate as a point of price attraction.* What does the author exactly mean by this new point of price attraction? He means the sum of the total costs of the monopoly enterprise, and its global profit according to the global profit rate. The global profit rate is the mean value of the monopolies' full profit rates. The monopolistic production price aggregate is not a market price, but the author calls it a differentiating *point of price attraction.* In addition, the monopolistic price system includes the monopolistic production prices *per product,* expressed *in the trend of their price centre* and, on the cyclical average, in that of *market prices.* These are the most exciting chapters of the book, since economic theory has long been *owing an explanation of the monopolistic price without abandoning the law of value.* Accepting the classical form of the production price as a price centre under the conditions of *monopoly as a system* has resulted in the monopolistic price appearing as a market price *permanently deviated* from the regulatory centre. This is to say, practically, that under monopoly capitalist conditions inequal exchange is the rule i.e. the tendency in the long run. It is the great merit of *Kálmán Szabó*'s book that the law of value is "rehabilitated", i.e. the necessity of equal exchange is given theoretical support.

What can be seen as a fault in the book is the narrow scope given to the term "modern", which is also used in the title. What is involved? Between the systems of capitalism and socialism, there are several similarities in the material-technical basis, technical-economic conditions, enterprise structure, and certain elements of the mechanism. Therefore, it could have been specified – in accordance with the specific features of the socialist system – in what respect the discussed particularities of the changes in the monopolistic price (changes in income) may appear *in the socialist theory of commodity and value, and of price and income.* Thus the contents of the book are somewhat narrower than what is promised by its title. The book could have made a more direct contribution to the elaboration of the socialist theory of monopoly and to the analysis of regulated enterprises which are often in a monopolistic position.

The book provides an intellectual experience of lasting value, as well as highly useful professional information to theoretical economists, teachers of political economics, and even to practical economic policy makers.

L. NAGY–E. ÉGETŐ

T. SÁRKÖZY: *Egy gazdasági szervezeti reform sodrában* (In the drift of an economic organizational reform). Magvető Kiadó, Budapest 1986. 431 p.

"Time has run out", the author says in his postscript to the book. "We have had a serious time lag in developing up-to-date organizations, of which a great part can now be recovered. If, however, retrogression exceeds the average of such cases, if informal organizational functioning stops the development of modern organizations, time may come to a standstill for us. And yet: time has run out." Whoever reads the book will certainly agree with this simple sentence. Or, perhaps he will add: and yet there was time, more exactly, there would have been... Let us now see the forces active in the drift of a reform of economic organization.

One of the major values of this book, which relies on a vast knowledge of material and data, is the unusual freshness of its information about the preparations, exclusive debates and compromises of a very important economic-political decision – as well as its coverage of some of the underlying causes. From the Party Central Committee resolution of April 1984 to sending the manuscript to press, less than a year had passed.

The reader is informed by the foreword that the book owes its birth to incentives coming from top levels, and that the author's heart is divided. He proudly declares himself a technocrat, having attended to some important duties in the course of the preparations for the book, although "it is quite another thing to write as a social scientist." (p. 17) Insider or outsider, the dilemma is no novelty in the history of the Hungarian intelligentsia – however, the open admittance of the fact is less than traditional. "Whoever takes part in such activity (namely, elaboration of the conception – G.R.) is to some extent a "tailor" who makes what is ordered, and if what is ordered is a bathing suit, he can hardly make a dinner jacket". (p. 18) Now let us see the suit which is – and it is not surprising – a mixture of the two: a matter-of-fact and specialistic report, a (self-)critical analysis worried about the reform, accusation and defence, "legal formula" and pamphlet. Thus, whichever way we look at it, it is a remarkable work.

The most frequently recurring element of the book, which is divided into three parts (What happened; How it happened; What is before us), is the warning against the danger of *retrogression.* The concept is right there in the introductory pages of the first chapter. The following can be read: "The modernization of the central *economic control and management,* and in it mainly the transformation of the sectoral management structure, constitute the *basic condition of an appropriate functioning of the new forms of enterprise.* Yet the political opinion has been formed that in an international political and economic situation full of tensions, a simultaneous transformation of the central economic control and management system and of enterprise organization would amount to *serious political risk.*" (author's italics) However, looked at from this angle changes which are limited to minor corrections made in the functional and sectoral ministries merely open the way for *"a strongly retrograde tendency"*. "The organizational stability of economic management and control may render the new forms of state-owned enterprise formal." (p. 26) This risk, however, must be taken – again according to political opinion – and further progress may be made in the 1990s. "The final decision was concerned, therefore, with an organizational reform of state-owned enterprise, basically concentrated on industry." (p. 27) In subsequent chapters of *Part I,* this "independent sub-reform" is set forth and evaluated.

1968 offers itself for comparison. As a result of the compromise made in that year, the organization of control was left unaffected, with the prospective of a future, second step (envisaged for 1970–72). Thus was born the institution of economic management through enterprise control, which the author justly describes by the expression "virgin prostitute". Namely, "economic control and management relying on supply responsibility", a typically "neither plan, nor market" state of things. "In the field of organization, the basic dilemma has always been, Tamás Sárközy writes in commenting on this period, whether the sectoral economic ministries can adapt themselves to the priority of a non-hierarchical, sectoral form of economic policy control and management; or will it be a vegetative form of functioning? That is, will the old form of organization prevail against the new contents? " (p. 241)

Mutatis mutandis, the question has lost none of its topicality after twenty years. On the contrary, the risk of the "independent sub-reform" – the author's term for the 1984 decree – is greater. Namely, beyond the fact that it is not promoted either by political reform, or by reform of the organization of economic control and management, the economic and social conditions of its coming into effect are incomparably worse than were those of 1968. In addition, with the concentration of legal and market control into one place – "into ministerial hands" – realization can only take place very slowly. This is because the aversion on the part of numerous enterprise managers, and the contrary interests – specified in the book – of the trade unions and of sectoral ministries all together as well as individually are apt to question, and "politically discredit" (author's expression) the principles of 1984, and the attempts to further develop them as planned. Yet, time has run out. However, while warning against these risks (of retrogression), the author reports in quiet resignation on the manoeuvres of the last twenty years and those seen in the course of preparing for the 1984 decision, all aimed at stealing back or preserving some forms of the old (hierarchical) methods of exercising power and control. The chapters entitled "The battle fought for enterprise law", and "Fight for control of lawfulness" provide fine examples of economic and power competitions taking place behind the scenes. One example is the wrangling (renewed from time to time) over supply responsibility, which has been going on for a decade. In vain is it laid down by law and government decree that there is no such thing as supply responsibility, for the concept holds fast and keeps popping up – either serving enterprise, sectoral, and top-level political interests, or occurring in battle-cries through the mass media. Of course, as long as we are talking about supply instead of trade, as long as there are abstract declarations of responsibility instead of real failure (with its consequences at all personal levels), and as long as we explain shortage instead of eliminating it, we cannot expect this concept to finally die out.

"That criticism and self-criticism of the central economic management and control have been regularly exercised at the party congresses of the last twenty years, allows us to draw the conclusion that the errors criticized are not simply subjective, but are the outcome of constructional deficiencies." (p. 228) In *Part III* of the book the author makes some detailed and quite sensational suggestions for correcting those "constructional errors". This conception, comprising almost the total social-economic vertical from control to safeguarding of interests, has as yet – as far as I know – not been made public in such detailed explanation. Unfortunately it is difficult to present within the framework of a review. The author says he would be satisfied if

50 percent of his suggestions were put into effect. The reader may ponder over what could be dispensed with in the modernization process of the "overweight state". (József *Bognár*). Could it be the real safeguarding of interests (which is already no "conciliation"), of interests differentiated according to real needs and which could be organized from below – perhaps even "institutionalized" as a chamber of an extensive safeguarding of interests, functioning under parliamentary control? Or, now we have gone that far, could the suggestion be dispensed with, that "efforts must be made to more definitely mark off the scopes of the leading bodies of the party, and of the Cabinet... as a consequence, *to increase political independence of the government...*, to resolve the exclusively regional organization of parliament, and to let the interests of the different groups of society be more strongly represented in parliament"? (p. 284) A long list could be made of the reform conceptions set forth in the third part – "What is before us" – concerned with social control, greater publicity, and the assertion of various, freely confronted interests – namely, with the process of *democratization.*

I wish to call attention to just one of the reasonings (and suggest it for further consideration): "the actors of the central level of interest conciliation processes make compromises and establish priorities which are necessarily subjective; there is not just one straight way, and what seems advantageous in the short run may entail serious disadvantages in the long run, and *vice versa.* Also, the different national economic interests are represented by individuals, groups, and organizations. They all supply an "ideological foundation" of their own interests, experiencing them, or making them appear, as social interests. There is not *and cannot be such social interest* which is not intertwined with individual, group, and organizational interests – thereby I do not claim that social interests are simply the resultant of individual or group interests." (p. 391) The question remains concerning what social – or, more narrowly, national economic – interest exactly is. What does the term used in a reflex-like manner mean (conceal), if not a resultant, practical and final manifestation of a formal and informal bargaining process? The author seems to support this view a few pages later, quoting the example of the Western countries' practice in asserting interests. "Representatives of economic interests have achieved a situation in which they are increasingly drawn, formally as well as informally, into legislation, administration, and economic regulation. 'Private government' has developed: national economic planning, and the strategic decision-making of economic policy are practically based on the special tripartite system of agreements of state administration, capitalistic concerns and trade unions... Hungary can obviously learn a lot from these institutional systems." (p. 405) Let me refer to the excellent work "Forty years of the Hungarian economy", by I. *Pető* and S. *Szakács,** and in it especially to the part (pp. 343–349) describing the 1956–1957 conceptions of economic management and control and safeguarding of interests. The propositions formulated at the time – Hungarian Peasant Federation, National Industrial Chamber, National Agricultural Chamber, Cooperative Chamber, National Economic Council – though not put into practice, may still be instructive.

The most enjoyable chapter of the book bears the title: "The chances of mastering over-regulation". Although the exposition of twenty pages organically fits into the whole of the book, its individual publication would also be well justified. The author analyzes, evaluates and documents the phenomenon from all possible aspects. "To explain" the 18 thousand(!) pages of effective legal regulations (without the local government regulations), Tamás Sárközy gives twelve causes of over-regulation. He is not content with any obvious explanation – such as the dumping of rules accompanying hand-steering necessitated by a crisis situation, or that over-regulation is a self-intensifying process (namely, going into minute details is bound to lead to contradictions, so that new regulations are necessary). Instead, he points *to the causes arising from the deficiencies of the decision-making system.* For example, that legislation lacks consensus, that delicate questions are

*See a book-review on their work in *Acta Oeconomica,* Vol. 36, Nos 3–4 (1986) pp. 349–351 by Á. Török.

ignored or deformed into compromises which are already useless in practice, and that the question of asserting interests is solved by a proliferation of enforcement orders. Legislation may also be merely a matter of prestige, the legal "cover-up" of the lack of judicial independence, and economic troubles, e.g. shortage. The most interesting of the explanations, in a highly appropriate manner, points to the legal disguise of efforts at retrogession. "If, for either objective or subjective reasons, an operative economic hand steering inconsistent with the basic principles of the economic reform is going on (albeit – for political reasons – without the intention of changing the acts containing these basic principles) the importance of low-level, latent pseudo-legislation will necessarily increase." (p. 319) At the end of his essay on over-regulation, the author outlines his great vision: "If the government control of the economy can be strengthened, and the present role of functional and sectoral economic management and control organs revalued, if enterprises can be consequently detached from sectoral ministries, and if the autonomous forms of state enterprises are stabilized, then, in my opinion, *a comprehensive constitutional reform* would become feasible. This would legitimate the realization of the state's economic function – reinterpreted with regard to contents, organization, and methods." (p. 322) If. . .

G. REJTŐ

ASLUND, A.: *Private enterprise in Eastern Europe. The non-agricultural private sector in Poland and the GDR, 1945–83*: (Foreword by Wlodzimierz Brus). The Maximillian Press Ltd., London-Basingstoke 1985. 294 p.

Aslund is an eminent representative of the new generation of Western scholars that is trying to reveal the structure and regularities of the post-war socio-economic systems of the Central-Eastern European region by means of a detailed description of events and processes, with as little ideology as possible. The subject of the detailed analysis and description is, as a rule, a clearly delimited sphere of the events and actors involved in economic development. It seems that the empirical researchers of the Soviet-type societies leave it to future generations to formulate broader regularities.

Aslund proceeded in this manner in choosing the non-agricultural private sector of two European socialist countries: Poland and the GDR, to be the subject of his analysis. The reason why he opted for these two countries is that there private industry and trade have more weight in the economy than in other socialist countries. As he says, the third country that should have been analysed in the book is Hungary, yet he did not get round to it. His sources were statistics published in the two countries in question, laws and regulations, party decrees, speeches and writings of state and party leaders, and Polish, East German and Western literature on the subject. The information thus obtained was then contrasted and completed with a number of interviews made with Polish and East German entrepreneurs. The author handled his sources with competence and with the necessary amount of reserve. He is aware, for example, that numbers may be badly distorted by tax regulations.

He confines his study of the non-agricultural private sector to enterprises functioning on the basis of a legal permit. His analysis covers that part of the economy in which enterprises: 1. hold licences, 2. are managed by private persons, 3. in which profitability is the condition for their survival, 4. take risks, 5. are not cooperatives. It is known from *Rupp*'s analysis [1] that the Hungarian (and probably the other Eastern European) entrepreneurs are very flexible in changing the forms of enterprise. The changes are not only important indicators of their ability in organizational innovation, but an important element also of the tactics they use against the state. If it is in his interest, the small entrepreneur will legalize his activities; another time he will transform a subsidiary enterprise into a state-owned small-scale enterprise or cooperative; or he will take out a licence, if the terms of taxation and the prospects of growth seem more favourable in this way. At other times, when conditions are against him, he will not hesitate to embark on illegal activities. As secondary economy is not, or only incidentally, the subject of this book, with respect to this topic the reader gets little information about switch-overs in the forms of ownership, and the flexibility of German and Polish small-scale entrepreneurs. Such information missing, the central topic of the analysis becomes, almost automatically, the relationships of the state and the private sector, and within this especially the behaviour of the state and party. The reader often has the feeling that the real subject of the book is not the private sector, but much more the policies towards small-scale industry and trade, and thus the political system itself. All this, however, does not diminish, but rather increases the attraction of Aslund's analysis.

The book is composed of three parts. *Part I* and *II* discuss, respectively, the history of the private sector in Poland and in the GDR, and in *Part III* the author attempts a static and a dynamical comparison of the private sectors of the two countries.

The Polish story shows more likeness to the Hungarian one [2] than the East German story. During wartime, the Polish communists promised that only large-scale industry and large estates would be nationalized after the liberation of the Polish territories. However, they adopted a number of measures against blackmarketing and speculations which were (partly) directed against private enterprise. An example of such a measure was the egalitarian monetary reform under which only a fixed amount of old currency could be changed for the new one, and the restriction of tax conditions was to promote the same end. In the latter case it was not only increased tax burdens that made entrepreneurs feel uncomfortable, but also the circumstance that new taxes could be imposed any time. The profit rate was maximized, while state-owned trading enterprises used dumping prices when competing with private trade. Economic police activity was started, mainly against commission business. The system of licensing was one of the important weapons in the transformation of the forms of ownership: certain trades were quite unexpectedly excluded from the sphere of legal activities. Already at that time, in 1948, when the so-called "battle over trade" was being fought, the typical reactions of fear appeared: "private industrialists avoided investment outlays; they preferred to produce goods they could sell at high prices in uncontrolled markets; they strove for easily changeable activities which made a large share of enterprises fluid and technically primitive;".

The years 1949–1956 are called by Aslund the period of "full Stalinism". The private sector was shrinking fast. It was not made to shrink by lawful nationalization, but by confiscation of private enterprises, and withdrawal of licences. The bodies for the safeguarding of interests of artisans and tradesmen were also reorganized: branch chambers were replaced by regional ones. The speed of the changes is clearly reflected in the fact that in 1947, 20.7 percent of the government's tax revenues came from the non-agricultural private sector, yet in 1955 this figure was only 1.2 percent.

After Stalin's death, in 1953–54 the Polish state mitigated the harshness of its policy towards the private sector. Achievements of the sector were praised at high forums. Also the terminology changed: not private, but 'individual' enterprise was spoken of in the papers. The détente, however, did not last long. Already in 1954, a new wave of harshness hit the private sector. State-owned enterprises were forbidden to buy from private industry, taxes were further raised, the permitted number of employees was reduced to one, and again a number of licences were withdrawn. The purpose of these measures was to compel as many private artisans as possible to join cooperatives. Subsequent analyses – made in the late 1950s – showed that the forced collectivization failed to bring the results the central power expected: the fixed assets of the socialist sector did not grow – instead, shortage did. At the same time, skilled artisans went into large-scale industry in large numbers, and were employed as semi-skilled workers.

In 1956 new leaders took over in Poland and they assigned a role to the private sector in easing shortages and economic tensions in general. According to Aslund, a relative stability was characteristic of the period 1956–57. The advantages of small enterprises were once again recognized, as well as the fact that private small trade is an important channel of exchange between village and town. In the plenary party meeting in June 1956 the policy towards the private sector was officially changed, however, as Aslund remarks: "They obviously thought of ordering private enterprise to accomplish what socialised enterprises had failed to do." The author qualifies this approach as "input-oriented", in which political power wishes to have unused production factors operated by private entrepreneurs, without, however, taking into consideration the interests and conceptions of the latter.

The situation was made even more complicated by the circumstance that Polish economists, engaged at the time in working out an economic reform, were generally averse to the private sector. Even O. *Lange* – who was committed to the reform – condemned commission business, and the importance of the sector was recognized only by E. *Lipinsky* and Cz. *Niewadzi.*

After the party decree had been issued, a significant change took place in Polish private small-scale industry and trade. The number of small enterprises began to grow fast, and in this growth an important role was played by the credits raised by the sector. There could have been an even more robust growth if private enterprises had not had to struggle with material shortages, and high taxes. Regeneration was, however, even "too" successful – the opponents of the partial reprivatization soon launched a heavy press compaign against it, in particular against retail trade. It became clear at that time (and it is confirmed by numerous Hungarian cases) that the adherents and representatives of the system tend to be especially intolerant of the first phase of market development, this phase being concomitant with much speculative activity and illegal extra profits. Criticism levelled against these phenomena, as well as against the one that trade was not settling in villages but in busy town districts, was widely approved. In the meantime, trade unions protested that in the private sector the number of organized workers was less. The new policy makers expected the small enterprises mainly to fill the vacuum which existed in the service sector. However, small enterprises wished, similarly to industrial cooperatives, to produce rather than to undertake services, and this was yet another source of tensions.

Therefore, not even the stabilization period was free from tensions and uncertainties. Quite a number of private enterprises were wound up, there were strong fluctuations in taxation, licences were – though with less frequency – still withdrawn, and legal proceedings were instituted against some of the private entrepreneurs. Yet the events that worked towards stabilization of the sector should not be underestimated. As such, the author mentions, in the first place, the strengthening of cooperation between the state and the private sector, and the modernization of some of the private enterprises. In Aslund's appreciation: "The state had merely become more tolerant, leaving the private sector legally degenerate.".

The period of relatively peaceful coexistence ended in 1967. A faction of the party leadership, headed by M. *Moczar,* started a harsh campaign against the private sector because of the income differences between entrepreneurs and other social groups. According to the author, these differences would not have been so high if the basis of comparison had not been the average wage, but the wage the entrepreneurs could have earned in state industry. Yet the authorities took a series of restrictive measures to drive back the private sector. Automation was not permitted in private industry, engineers were not granted licences, in 1968 an upper limit of deliveries to state-owned industry was set, and taxes were raised. Because of all this, the number of people operating in the sector fell by 33 000.

In 1970 a new leadership came to power in Poland, with E. *Gierek* at the top. Soon the policy of rapid development of large industry was announced. In the projects of the new leadership, no particular role was assigned to private industry and trade. For example, the government Committee of Small Industry was dissolved, and the new five-year plan intended to increase the sector's output without investments. All this was not directed against the private sector (social insurance was extended at that time so as to cover private entrepreneurs as well), it was only that the economic successes of the early 1970s blinded leaders to reality, and they failed to take into account the results achieved by the private sector. The existence of the sector was indicated for them mainly by the competition for labour (which is sharper than the average in periods of accelerated economic growth).

The policy of forced industrialization did not result in success: in the mid-1970s the domestic market situation was worsening and in

1976 there were already strikes signalling increased discontent among the Polish population. At that stage the leaders started to pay more attention to private industry: as a part of the "manoeuvre" to mitigate the disadvantageous effects of the earlier economic policy, a programme was elaborated to develop small-scale industry. The manoeuvre – as we know today – was also unsuccessful, and the Polish economy, industry included, was precipitated into a worsening crisis between 1976 and 1980. Somewhat paradoxically, the private sector started a vigorous growth exactly at that time. This process, concomitant with modernization and the growing weight of new and dynamical branches of development, continued in the critical 1980s. A particularly interesting new development is the appearance of foreign-owned enterprises on the Polish market. There is again press criticism, not of the sector's output, but of the owners' high incomes. Also, the authorities are not pleased about these enterprises not producing what is "expected" of them, but what the market wants. The recent stabilization period is, therefore, not free from tensions, either.

The history of the GDR's private sector widely differs from the Polish (and the Hungarian) story. This country was the Soviet-occupied section of Germany, and explanations have to be sought in the special situation of the GDR, and in the topicality of the German issue. In addition to differences in policy, economic regularities functioned in a different manner: as long as borders were not closed, there was a lively competition on the commodity and labour markets between the two zones, and later between the enterprises of the GDR and the GFR.

During wartime German communists, like their Polish colleagues, came forward with a programme assigning an important role to the private sector in the future. They, however, unlike their Polish colleagues, took this programme seriously in the postwar years, and the establishment of the German Democratic Republic brought no change in the tolerant policy towards small entrepreneurs. While private activities in the other Eastern European states were drastically curbed, nothing much changed in the GDR economy: neither small- and medium-scale industry, nor small trade was nationalized. On the other hand, wholesale trade was nationalized, on the ground that wholesalers were blackmarketing and causing shortages on the market. In Aslund's opinion, this was not the only reason, for it was believed that, if wholesale trade was under control, it enabled a kind of "indirect socialization". Material supply to private enterprises was permitted subject to making and fulfilling certain delivery contracts. The equalizing monetary reform was not pleasant for small entrepreneurs in the GDR, either, and it was a sign of the new era that the new state tried to extend planning also to the private sector. Beside the linking up of material supply and deliveries in the manner mentioned above, the same end was promoted by the small entrepreneurs' chambers, the purchasing cooperatives, data supply obligations, and the system of issuing licences. Characteristically, no licences were granted to entrepreneurs' children, licences could not be sold or transferred, and were valid only up to the age of retirement. Taxation was not neutral, either, but involved many disadvantages for small entrepreneurs. As in Poland, a few entrepreneurs were expropriated by the state in the GDR, although the entrepreneurs concerned received indemnification.

In 1952 the Soviet position changed with regard to the German issue, and this soon made its effect felt on the GDR domestic policy, and thereby also on small entrepreneurs. The antifascist democratic system came to an end and the building of socialism began. The taxation of the private sector was raised considerably, and small entrepreneurs responded to this policy by emigrating in large numbers. By mere chance, however, the hard period lasted only about a half year. Namely, Stalin died in March 1953, so that the subsequent liberalization process of Central-Eastern Europe did not have to be started from zero point in the GDR. Very soon a State Secretariat of Small Entreprises was formed and chambers were reorganized – though the latter on the regional principle. However, the greatest sensation of the "new phase" of the GDR was that 347 nationalized enterprises were reprivatized, and 2805 enterprises that had been wound up were re-started. This is an example showing that, under given conditions, the leaders of a socialist economy can and do avail themselves of this means of improving efficiency. The measures were followed by improved economic results, diminished cooperation difficulties, and improved supply to households. Very soon the inevitable consequences of a thriving private sector appeared: growing competition on the labour market for the well-trained and industrious workers, increasing income differences between entrepreneurs and other groups of society, and intensifying concentration of capital within the sector.

The question then arose, what should happen to the accumulated capital? The rulers of the country condemned luxury consumption, and they did not support private crediting, either. In the 1950s, however, party and state leadership showed equal interest towards the cause of the private sector's development. That the sector was necessary was not questioned and, what is more, the 1956 events of Hungary and Poland were, according to the East German press coverage, related to thoughtless and exaggerated policies of nationalization. In this phase, there were various signs indicating that, in the GDR, the coexistence of the private and the state sector was planned for the long run. Not only were the classics of Marxism often and readily quoted for their explications of state capitalism, but the two forms of the latter – semi-state enterprises and commission agencies – were widely applied. The latter comprise private traders working on a commission from some socialist wholesale trading enterprises. Both forms have the advantage that there are no limits to growth, whereas their disadvantage – which was recognized in the contemporary GDR literature – is that neither the owner-directors, nor the state are in fact interested in investments. Both parties sensed the transitory nature of these forms, even though Aslund's partners in the interviews all said the presence of the state's representatives was perfectly unobtrusive. As a rule, the officials delegated to the board of directors visited the enterprise once a year.

In the late 1950s, significant changes took place in the economic policies of the socialist countries. In the Soviet Union and, following her example, in the GDR as well as in the rest of the socialist countries, economic growth was accelerated so as to catch up with the advanced capitalist countries. In the GDR, nationalization was one of the means of this acceleration. The main target of the campaign was not the semi-state, but the real private sector: taxes and political instruments were resorted to in an effort to drive entrepreneurs towards the socialist sector; these attempts were not without results, as is shown by the 63 percent reduction of their number between 1957 and 1960.

Socialization affected agriculture, too. The reorganization caused supply difficulties, industrial output deteriorated, and these factors led to a slowing down of the rate of economic growth. Therefore, the campaign of nationalization was stopped and in 1964 the New Economic System (Neues Ökonomisches System) was introduced. In the new system, reformed but still operated mainly by means of directive planning, the position of the private sector became stable. There was no question of it having to be liquidated, although private and semi-state enterprises were still integrated into the planning system. A new form of this was the system of product groups. State-owned, semi-state and private enterprises are listed with each group of products and the plan specifies the quantity of the given product to be manufactured by each enterprise, as well as the amount of raw material they were to get. In the 1960s, the new planning system did not hinder development of the private sector. The upswing, however, was concomitant with the usual side-effects. The reproach was repeatedly made that small entrepreneurs earned too much, and that semi-state and private enterprises snatched away the best workers of large-scale industry. Furthermore, the competent authorities were not pleased by the fact that, contrary to expectations, the main growth of private enterprises' activities was not in the field of services.

In 1970, there was another revision of the economic policy, and the row of centralization and administrative measures entailed in it put an end to the almost ten-year period of relative quiet. Within a few months, the greater part of the semi-state enterprises was nationalized. While in 1970, 14.3 percent of the employed worked for semi-state enterprises, a year later it accounted for only 7.6 percent. In most cases, the owner-directors freely offered their wealth to the nation – in exchange the state left them in their position in the enterprise and they received indemnification. In Aslund's opinion, the reason for the sudden change is not quite clear, since the sector's output was better than the average. The controlling apparatuses may have been driven towards taking such a step by the above-mentioned side-effects (income differences, competition for labour, etc.). Nationalization was expected to leave the sector's advantages intact, and to eliminate its disadvantages.

The outcome was, however, different. The innovation results of the nationalized enterprises became poorer; shortage in their markets did not decrease, but rather, increased; the owners of the enterprises avoided by the nationalization campaign made no investments; quality deteriorated; and the entrepreneurs appeared on the illegal markets more frequently. In the late 1970s a change took place in the GDR, again favourable for the private sector. Even though belated, licences were again issued and credits granted in an effort to stabilize the number of private enterprises.

In the last chapter, Aslund compares the non-agricultural private sectors of the two countries treated in the book. In both countries, this sector provides 2–4 percent of the national income, its capital efficiency is high, and its productivity lower than the average. It is a further common characteristic that even successful entrepreneurs invest little. It is a difference that the Polish entrepreneurs are relatively richer, and they are more market- and less product-oriented. Unlike their Polish colleagues, entrepreneurs in the GDR aspire for a sound income and are not after short-term profit in fashionable branches.

In can be said in general that the socialist sector is unable to satisfy certain market needs. Therefore, the private economic sector has not been liquidated in either country; rather, first of all in Poland, it has been "legally degenerated". Within this long-range process, using the Polish example, Aslund observes a special cyclical movement in the relation between state and the private sector. In its first phase, the state liberalizes, so that the thriving of a legally functioning private economic sector should suppress the black market. The expanding private sector exerts this effect, but it also draws away labour from large industry, entrepreneurs' income are too high, etc. The desired state of the markets is hardly reached when private entrepreneurs begin to be sharply criticized. This leads to restrictions, which leads again to worsening shortages, and so the process starts all over again. The condition of the cycle to be elicited is that the sector is relatively unimportant and perfectly corrupt, thus sufficient reason is provided for intervention. In the GDR, only traces of the cycle are evident because the process of legal degeneration has been slowed down by several factors – for example, the unusual shortness of the Stalinist period.

M. LAKI

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