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CONTENTS

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TRANSITION FROM STATE SOCIALISM: WHERETO AND HOW? (COMMENTS ON THE INQUIRY CONDUCTED BY *ACTA OECONOMICA*)*

L. SZAMUELY

In 1992 *Acta Oeconomica* conducted an international inquiry on the problems of transition of post-communist economies to a market economy. Thirty answers by distinguished scholars and experts were published in Vol. 44. Nos 3–4. of the journal.

The author of this study analyses both the answers of some respondents and the crucial problems of the present situation in the countries of Central and Eastern Europe earlier belonging to the now defunct Soviet bloc. He discusses the content of transformation consisting of a number of simultaneous but different processes that demand different treatment. The requirements of macroeconomic stabilization sometimes collide with the needs of systemic change. The social consensus which is so important for the process of peaceful transition cannot be maintained by the fashionable blueprints of the neo-liberal school of thought either. The prospects for the future are rather bleak but different for the various parts of the region.

> *Question*: What can be worse than communism?
> *Answer*: What comes after.
> (Common saying nowadays in Eastern Europe, quoted—*inter alia*—by François *Fejtő* (1992)).

The bicentennial of the Great French Revolution, the *annus mirabilis* of 1989, promised to become a prologue to the regeneration of the Central and Eastern European societies situated on the eastern side of the former Iron Curtain. Though the promise is still there, a great deal of hope has gone sour. The area of the now defunct CMEA/COMECON has turned into a crisis zone of the world economy. The GDP of these countries in 1992 was at least one third below the level of 1989. (Even in the relatively better-off Hungary the fall was about 20 percent.) According to a comparison made by experts of the U. N. Economic Commission for Europe the present fall in the GDP of six Central and East European countries (without the former Soviet Union and Albania, but including Yugoslavia) is deeper than it was during the Great Depression of 1929–34 (*ECE* 1992, p. 44). This region has never suffered such a big loss of national income in peacetime (this statement is

*The author is indebted to A. *Köves* for this helpful comments on the first draft of this essay. Most of his valuable remarks have already been taken into account in the present version. Nevertheless, the study expresses the strictly personal views of the author.

not valid, of course, for the warring successor states of former Yugoslavia). Yet this is still not the end of the story. At the time of writing this article (in January 1993) we cannot but hope that the bottom of the trough will at last be reached this year—at least in Poland and Hungary; the situation in the recently separated territory of Czecho-Slovakia is at present unpredictable.

The real dimensions of this economic disaster were already perceptible when the editors of *Acta Oeconomica* prepared a questionnaire that was sent out in the first quarter of 1992. Nevertheless, while formulating the two questions[1] they apparently followed the then-prevailing neo-liberal approach to the problems of the transformation of the centrally planned economies (CPEs). According to this rather simplistic and reductionist view the essence of the transformation process is a systemic change (i.e. change-over to political democracy and market economy), and the whole mess will be cleared up when a proper set of institutional changes is introduced. So, the task is to find this set of measures and techniques and to implement them as quickly as possible.

The present author has to admit that he refused to take part in the inquiry because he considered this approach to be futile in solving real problems that were already taking tragic proportions even at that time. Concerning the questionnaire itself, he thought that it was misleading and doing disservice to the international community of scholars who influence decision-makers both in the East and in the West. Having read the answers of respondents—that were published in the previous volume of *Acta Oeconomica (Debate* ...1992)—the author can now say that his misgivings have only been partly justified. They proved to be justified inasmuch as a great number of contributors also disagreed with the reductionist approach that inspired the inquiry. However, this fact also shows that the scholars and experts had learned a lot from the experience of the past two or three years. Thus a great many of them showed in their replies that they are not at all enthusiastic about the simplistic solutions suggested by the adherents of the neo-liberal school.

In fact, the inquiry turned out to be useful because it has provided a variety of different but generally well-founded views, sharp-minded analyses, or simply guesses concerning the present developments or possible outcomes of transformation that is taking place on the ruins of the greatest—and bloodiest—socio-economic experiment in the history of mankind, which was called (rightly or wrongly) Socialism.

This article is not going to summarize or evaluate the thirty different contributions. Its aim is simply to draw attention to some crucial issues of transformation of the former CPEs raised by the respondents to the *Acta Oeconomica* inquiry. The view expressed in the present article is strictly personal. The author, however,

[1] "What do you regard as the main barriers of the transition to a market economy in the post-communist countries? 2. What measures and techniques do you suggest to accelerate the transition process?"

has an advantage over the other contributors—because he is acquainted with their replies to the inquiry and thus he can attempt to benefit from this fact.

First, the present study deals with the content of the process of transformation of CPEs and looks for an explanation to the unprecedented economic slump and possibly lasting depression. *Second*, it deals with the strategies for economic recovery and restructuring; namely, with problems of stabilization and privatization—which sometimes look like a dichotomy. *Third*, it weighs the chances of success and the conditions for securing it.

The content of the transformation process

The transformation of the European countries which formerly practised Soviet-type state socialism consists of a number of simultaneous and different processes. For instance, Béla *Kádár* emphasizes in his contribution, that "beside the change of economic model, a further important aspect of the transition is the change of political model, the change of path of economic growth, and the change of emphasis in foreign trade". (p. 294)[2]

These processes are interconnected but sometimes also contradictory. The contradictions cannot be simply viewed as barriers to be removed by proper and/or opportune legal regulation or a particular organizational technique. In our perception the main processes of transformation go far beyond the institutional changes in politics or economy that the notion of systemic change implies.

(a) In *the domain of politics* one-party monolitic state socialism has been replaced by pluralistic political regimes. Though in some countries these regimes can hardly be called parliamentary democracies (for instance, in Russia and some other post-Soviet successor states no nationwide political parties exist), there are everywhere political groups or individuals who in their struggle for power openly compete for the confidence of the electorate, the citizens and—what is an extremely important phenomenon—of international public opinion in order to gain the much needed foreign economic, political and other support.

The political process making progress towards establishing democracy coincided with the fall of the Soviet empire and the decolonization of its outer zone and inner core. *Thus in many cases the efforts to create a liberal democracy have coalesced with the striving for national self-determination, separation, and the foundation of pure national states.* The latter dream of founding new national states is behind time by one or two hundred years, at least in Europe.

These two kinds of endeavour can come up against each other in countries with multinational societies or simply with ethnically mixed populations. As the

[2] Here and below the page numbers in brackets refer to the Debate...(1992)

supremacy of one nation over the population of a particular territory is secured by the exclusion of the other(s) and/or by its (their) forced assimilation, this means a death-sentence for the new-born democracy.

(b) In the *domain of economy a mixed market economy based on private property is emerging* in place of the centrally-managed, non-market economy. The privatization and the introduction of profit-orientation, and the appearance of market competition cause considerable social shocks and tensions. In the former CMEA member countries the crisis situation is aggravated by three additional processes.

First is *the loss of the so-called Eastern market and the compelling need for external economic reorientation*. As is well-known, during recent decades in every former CMEA member country's foreign trade the share of other member countries was around 50 percent. In all probability this share of intraregional trade was inflated by the price distortions and the artificially fixed exchange rate of the so-called transferable rouble against the convertible currencies. However, in addition to the probable distortion of the statistical data the latter certainly included the immense share of the "overtrading" in intraregional trade, i.e. the mutual deliveries of non-marketable goods unsalable elsewhere. The reason for this phenomenon was primarily political for it also involved the aims of defence policy. The strong effects of protection on the closed CMEA market and the preservation of obsolete economic structures can also be counted among the reasons. The collapse of the CMEA inevitably put an end to "overtrading".

This aspect of the intra-CMEA trade should be kept in mind when reading J. *van Brabant*'s contribution. Van Brabant blames the "managers of transitions" (the national governments?) for "ignoring opportunities for gradually phasing out the heavy reliance on intragroup trade and payments in the transferable rouble (TR) context, and seeking to replace it quickly with 'world market conditions' and/or near-instaneous trade diversion" (p. 242). Van Brabant rightly points to the harmful, even disastrous consequences of the quick disposal of the earlier trade system (pp. 245–246). Perhaps it is not only a kind of ex-post wisdom or crying over spilt milk if we stress that opportunities for gradual phasing out state trading theoretically existed and were even elaborated at an embryonic state by a group of Hungarian governmental experts in 1988.[3]

However, had the later developments followed this way of gradual change the share of the irrational "overtrading" would have been untenable and a steep fall in mutual trade would have been unavoidable anyway—albeit perhaps to a smaller degree.

Nevertheless, the crux of the matter is that the later developments *could not* follow this pattern. While admitting the hypothetical advantages of gradual change over the abrupt abandonment of the earlier system of state trading, we should not

[3] The proposals of the working group were published a year later in Hungarian; see Szamuely (1989). See also (in English) *Csaba* (1991/1992) and Köves (1992, pp. 59–77).

forget that actually it was not the introduction of the new system of payments in hard currencies which caused the collapse of the intra-CMEA trade. It was just the other way round; the sudden disruption of the Soviet economy—the hub of the whole CMEA system—and its disability to deliver the goods needed, wrecked the ship of intragroup trade. This is also the reason why the various new attempts to establish money-substituting payment systems like bi- or multilateral barter or clearing systems have up to now been doomed to failure.[4]

Thus, as a consequence of this big crash, enormous industrial and—in some countries—agricultural capacities have become idle and useless almost overnight. In order to survive the producers should make their way into earlier unknown markets where the rules of the game and requirements are totally different.

The other factor contributing to the deepening of the crisis is the *process of economic opening* itself. The macroeconomic adjustment of East European economies to the relative prices and cost levels of the world market means nothing less than undergoing now the same process of economic restructuring which the other countries of the world experienced at least from the mid-seventies, after the two oil price shocks. Then the market economies suffered the deepest economic recession since the Great Depression of the 30s. Now the former socialist countries are tormented by this process, in addition to the other troubles. They should wind up, or immediately "streamline" those economic branches which do not fit in with the structure of the modern world economy.

The third factor is *the abandonment of the policy of economic autarky*. This is a part and also a consequence of the economic opening. One of the basic features of the Stalinist so-called "socialist industrialization" was the purest type of import-substituting development. The countries of Central and Eastern Europe which fell under Soviet influence after World War II followed the same path. Now, because of the collapse of central planning, the domestic producers have to change their microeconomic behaviour. They suddenly find themselves face to face with the competition of imported goods even on their home market. These goods pour in from everywhere around the globe and very often are superior both in quality and in price. The wide assortment of goods coming in due to liberalized imports and/or foreign aid—although a blessing for the domestic consumers—can be a curse for the domestic producers for such imports push them out of the market. This can animate various xenophobic, anti-liberal and protectionist tendencies.

(c) From the point of view of social history the transformation taking place before our eyes is *a new endeavour in modernization* of the countries of Central and Eastern Europe. The latter always belonged to the periphery of the developed world. This is their new attempt to overcome their backwardness.

One of the promises of dictatorial socialism which had a definite attraction in the interwar period, and also for a time after the Second World War, was a

[4] Cf. Szamuely (1992), pp. 322–323.

promise of a short-cut in socioeconomic development. This short-cut was aimed at reducing the painful and long road of the private accumulation of capital, of the organic development of market economy, and of partaking in the severe competition of the world market. The main tool in the making of such a short-cut was a boost of accumulation by means of state redistribution of the national income and its allocation not according to the criteria of market efficiency but to those of governmental preferences. Now, after the attempt it is evident that the state socialist endeavour in modernization turned out to be a blind-alley, and the short-cut way of development caused a loss of time too, of at least half a century.

Thus the question is not simply whether the countries of Central and Eastern Europe are returning—as a consequence of the systemic change—to their starting point, and travelling (using the expression borrowed from Peter *Knirsch*) "the long way back to a market economy" (p. 303). This would be an absurdity anyway. The point is that the long decades of non-market economy wiped out the market institutions that had not been highly developed at an earlier date either. What is going on in many countries is a *return not to pre-socialist but to pre-capitalist conditions*. It is all the more so as the above-mentioned, crisis-deepening processes hit mostly the "modern" sectors of the socialist economy: namely, the large-scale enterprises in industry and the big—state and co-operative—farms in agriculture.

As the choice of modernization alternatives is again put on the agenda in Eastern Europe it becomes visible that between the countries of the state socialist bloc—often conceived of as a homogeneous concrete-grey edifice—there are still huge differences in the level of development. The great dividing lines of historical development are alive again.

Although in Europe the frontline of the Cold War confrontation roughly (but only roughly) coincided with the line separating Western Europe from the central and eastern part of the continent, on the Eastern side the difference between the historical heritage of Central and Eastern Europe disappeared. (It was present only for the ethnographers, art critics or researchers of religions.) It is enough to mention that the differences between the two regions go back to the great schism between Western and Eastern Christianity, to the different cultural and legal traditions of Rome and Byzantium, and later to the long-lasting marks left by the Austrian Empire and later the Austro-Hungarian Monarchy, the Turkish conquest and the czarist Russian Empire. It is in no way accidental that among the former CMEA countries it is Poland, the former Czecho-Slovakia and Hungary which show close similarities in terms of the present socioeconomic transformation. Also, it is not surprising that in the civil war leading to the disintegration of Yugoslavia it is Slovenia, Croatia, Bosnia and Herzegovina (once parts of the former Monarchy) which are opposed to Serbia and Montenegro. The demarcation line dividing Central Europe from the sphere of Byzantine culture or from the eastern Slavs who inherited it—not to speak about Moslems—lies, in fact, just there—to the east and/or to the north of the countries mentioned.

The collapse of state socialism opened again the almost eternal question of this region: *quo vadis* Eastern Europe?

For a great many of the respondents the answer is self-evident—towards (back or forward, it does not matter) a modern, capitalist-type market economy (e.g. *Andreff*, p. 220). In this respect the only difference between them is the duration of the transition, which varies from a few years, without explicit numbers (*Gomulka*, p. 277) to "two or three decades, not less" (Andreff, p. 225).

Quite a few respondents express their doubts about the possibility of achieving this desired goal at all. Among them it is László *Lengyel* who straightforwardly says that "existing socialism cannot be turned into a liberal capitalist market economy; ... it cannot be reformed and it cannot be revolutionalized" (p. 322). According to him "just as the preceding system was not a transition from capitalism into socialism and communism, so even the present one is not a transition from socialism into capitalism, but something entirely different" (p. 324). Though it is not very clear what this "entirely different" something should be like, from some of his hints—particularly from his references to the writings of C. Castoriadis—one can assume that Lengyel means a kind of bureaucratic (perhaps corporate) market capitalism burdened by an undemocratic (authoritarian? totalitarian?) political system.

No matter how unpleasant the above sounds, it is, alas, a realistic and feasible supposition, suitable to the complex and peculiar conditions of the present process of transformation in Eastern Europe. However, when stating "in Eastern Europe there is no redemption, either of a socialist, or of a liberal type", (p. 322) Lengyel partly contradicts his own grouping of countries of Central and Eastern Europe with regard to their chances of becoming market economies. He foresees little chance—or at least a very long period—of transition to market economy and mass democracy for the successor states of the former Soviet Union and for Bulgaria, Romania, Slovakia, Albania and Serbia while he puts Bohemia, Hungary and Slovenia right in the "anteroom of the market economic transition" (p. 325). It is interesting that one of the reasons why the latter countries are well-suited for such a transition is the fact that "at various periods these three countries have attempted to construct a human-faced socialism" (*ibid.*, 3rd footnote). How this statement squares with the fatalistic "no redemption" thesis concerning Eastern Europe (either under socialism or capitalism) remains an enigma to be answered.

Though Lengyel's historico-philosophical approach to the complex character of East European problematics is much more realistic than the reductionism of the neo-liberal school of thought, his pessimism cannot serve as a basis for a programme of socio-economic transformation.

Different and more practical reasons for scepticism concerning East European transition are expanded by Péter *Mihályi* and Peter *Knirsch*. Neither of them denies the possibility of progress towards establishing market economy. Quite the opposite, both stress that "market economy will come" (e.g. Mihályi, p. 332).

However, due to lack of material, financial, conceptual, institutional and human conditions "if left alone..., Eastern Europe will have no chance of closing-up in the worldwide competition" (*ibid* p. 333). Knirsch makes a similar point, though in a milder form: "structural changes connected with the change-over to the market system bring along high costs which in general have to be borne by the population of the reform countries. This is true even if there is considerable western support... In spite of all social measures a low living standard will be inevitable in the reform countries for a longer period of time that commonly anticipated. The resulting discontent can easily be abused by conservative circles to discredit all reform efforts" (p. 308).

Thus both contributors are not quite happy with the kind of market economy emerging from this process of transition. "What can be done?"—asks Mihályi. He attaches all his hopes to western aid, to an acceptance and introduction of a new edition of the Marshall Plan, but he does not think this idea has a great chance of realization. (Further on we shall return to the question of why the widespread expectations of a new Marshall Plan have been built on sand from the outset.) Knirsch, as we saw, does not expect a positive outcome either, even in the case of substantial western help.

So, the answer to the question *whereto* seems to be inseparable from the answer to another traditional East-European question: *what is to be done?*

Stabilization and/or privatization

According to the widely accepted conception of transition in order to transform a CPE into a market economy, you should implement a set of prescribed measures in a certain sequence. (One of the respondents to the questionnaire, Anders *Åslund* is quite serious when he puts this conception into a blueprint of 14 planks, pp. 234–235). If you want to have a market economy earlier, please accelerate the realization of this blueprint. (Does it not resemble Stalin's famous slogan: "Let's fulfil the five-year plan in four years"?) Market economy, of course, does not develop according to any blueprint and timetable.

Aleksander *Bajt* is absolutely right in pointing to the fact that "the process of marketization is inevitable and cannot be stopped" once a society becomes "post-communist", i.e. transformed into a pluralistic one where a multi-party system is established and no political barriers to marketization exist (p. 235). However, Hans-Jürgen *Wagener* is also right when writing that a market economy cannot be negatively defined—i.e. it involves merely the abolition of all restrictions, regulations, interventions etc. A well-functioning market will not be a spontaneous result of the mere dismantling of state regulation (p. 364).

It is a common view of scholars and politicians (and contributors to the *Acta Oeconomica* inquiry too) that the state should perform at least two indispensable functions—those of stabilization and privatization of the economy. It would be justified, of course, to widen this circle by including, for example, functions of restructuring, liberalization or rehabilitation of economy. The latter is a particularly important and timely task under the present conditions of the deep and probably protracted depression. Nevertheless, it is the stabilization and privatization of the economy upon which all other dimensions of the transformation of CPEs depend.

Macroeconomic stabilization, or macroeconomic adjustment (cf. *Bornstein* 1992, pp. 302–305) involves restoration of the main internal and external balances of the economy or at least sufficient reduction in imbalances. In fact, it means the stabilization of the internal purchasing power of money (holding down inflation, and establishing a market equilibrium between demand and supply of goods and services) and/or restoration of the external solvency of the national economy in question.

Privatization comprehended in a broader sense as de-statization, deregulation, commercialization of economic activity, or in a narrower but widely accepted sense as a transfer of ownership of state assets to private hands—means in both senses creation of market economy or its further expansion and development. In all these cases a complex of comprehensive and long-range institutional reforms is essential.

All that has been said above may look like truisms, and rightly so. However, the experience of the last two or so years shows a lot of misunderstandings of the meaning of these sets of economic policies and especially of their interconnections. Particularly distressing and sometimes even harmful is the fact that these misunderstandings govern not only the perception of the general public but also of politicians, national and international decision-makers and even learned scholars, too.

The regularly overlooked points of difference between these policies are the following:

The time horizon of stabilization and privatization is different

The accomplishment of a stabilization policy—generally an urgent task—should and usually is promised to be achieved in the short or at most medium term—i.e. within months or a couple of years. Of course, there are innumerable cases of failed stabilization projects and unfulfilled promises in various countries (mostly but not exclusively in the Third World), and as a consequence there is a continuation of the protracted periods of economic (and political) instability.[5] Nevertheless, in modern times all successful policies of macroeconomic stabilization have been carried out by governments in a really short time.

Privatization—either in its broad or narrow sense—takes time due to the complex of radical socioeconomic changes involved. Public enterprises run by a paternalistic state cannot be turned into racing stables overnight, even if a high authority decrees this.

Almost all contributors to the inquiry emphasize the time-consuming, long-term character of privatization. Many of them grasp the often misleading contradiction between the relative quickness and easiness of legislative actions and the rather slow development of market economy based on private property. Aleksander Bajt rightly points out that "as a real process, transition is a change in economic relations rather than in legal forms, and for this reason it cannot be achieved with a single stroke of the pen. The only overnight change, and needed from the very beginning at that, is the giving of full *freedom* to legal ownership forms" (p. 236).

The same point is made with utmost lucidity by Ellen *Comisso*: "governments can create institutions essential for the operation of competitive markets (from a commercial code to secure of property rights), but they cannot create a market itself. The latter results from the decentralized actions of individual economic entities responding to economic incentives only partially provided by institutional structures. As a result, the microeconomic structure of a market economy can only evolve gradually" (p. 253). Wladimir Andreff, as if he is going to sum up the conclusions made by other contributors (though he could not have read them), gives as the first advice to the leaders of the former CPEs: "Do not rush" (p. 225).

If these leaders ignore this pragmatic approach and go in for the prefabricated blueprints of the neo-liberal zealots by introducing a heap of institutional changes in a short time, it could lead—as János M. *Kovács* writes—to *"empty institutions"* which only simulate secular trends in economic history. "Market institutions may prove empty not only because they were either designed in an uncoordinated fashion or were not fine-tuned, but also due to the sheer fact that they *were* designed. In other words, having been introduced from above and in advance, they may lack human input (interests, routines, moral values, etc.) from below. Entrepreneurs who do not take risks, business agreements which are not observed, dormant companies which serve tax evasion, stock exchanges in which no transactions are made—one can cite numerous recent examples from Eastern Europe to show the quick introduction of capitalism can result in its similarly quick discrediting" (p. 312).

[5]The famous Hungarian philosopher Georg (György) *Lukács* used to recall that in his school textbook on history the following meaningful sentence could be found: "And this unmaintainable state of affairs held on for three hundred years."

Macroeconomic stabilization is a precondition for marketization but it is not necessarily true the other way round

There is no need to explain that a market cannot function properly without stable money and goods that money can buy—not to mention saving and investment, credit and banking, export and import activity. Restoration and/or stabilization of the main internal and external economic balances is the first and hardest duty of any government which intends to enliven a tottering or ruined economy.

The important feature of the macroeconomic stabilization is that it is always carried out or conducted by the government in a *centralistic way* in order to redistribute a share of the national product in favour of the state budget. This inevitably restricts, cuts and infringes upon activities, incomes, sometimes property rights of a certain, and not infrequently rather wide strata of the population. Even if these centralistic measures were temporary and even if they used fiscal, monetary and other legal means inherent in a modern market economy, this state dirigism nevertheless would move against the grain of free market activity.

Due to the contradictory, Janus-faced nature of macroeconomic stabilization, its consequences can lead in opposite directions. They can be the prelude both to the emergence of prospering market economies and to stabilization of non-market forms of state dirigism. Good historical examples for the former can be seen with the cases of the New Economic Policy (NEP) introduced in Soviet Russia in the early 20s, after the civil war; or in the case of the Erhard reform of 1948 in West Germany. In fact, the Balcerowicz reform of 1990 in Poland still has the chance to be a good confirmation of this option. In all these cases strong deflationary fiscal and monetary policies were combined with liberalization and deregulation of pricing, trading and entrepreneurship.

However, there are well-known historical precedents for the opposite tendency too. A very successful macroeconomic stabilization in 1946 in Hungary distorted the relative factor prices, and the lasting effect of this measure has, even up to the present, been a great drawback to the efficient functioning of the Hungarian economy. The cases of macroeconomic stabilization of the Soviet economy cruelly carried out by the Stalin leadership in the 30s and—in a bit milder form—after World War II, can also be mentioned. They successfully served stabilization of a command economy in its most rigid form.

Therefore, one of the main tenets of the neo-liberal school of thought, parroting by the mass media both in the West and in the East, namely that macroeconomic stabilization of the former CPEs can be accomplished *only by and through* their very quick mass privatization, has no theoretical basis or historical verification whatsoever.

Moreover, a wrong realization of this misbelief could in practice lead to the ultimate negative consequence: namely, *the reversal of the whole process of transition to market economy* in the countries concerned. For example, at the time of writing this article (January 1993) it seems a very real possibility that the failed attempt of macroeconomic stabilization in Russia, that was launched by the former Gaidar government in spirit of "shock therapy", has not only discredited the neo-liberal scenarios of transformation but also made way for stabilization cum restoration of central planning in physical terms. (In fact, this had already been suggested by the stabilization programme of the influential Civic Union in October 1992. (See *Programma* 1992.)

Macroeconomic stabilization can be a subject of "shock therapy", while privatization cannot

What is now called "shock therapy" is nothing other than a kind of very rigorous deflationary policy aimed at the restoration of external and internal economic balances. All stabilization policies have implemented it in the past using different degrees of rigour. The latter has depended on the circumstances—not only on economic conditions but on political factors too—namely, on the strength of the oppressing power of the state and/or on the strength of public consensus.

What is new with the deflationary policy of the latest fashion, is its pretention to be universal and instantly applicable—independently of institutional environment, availability of monetary or material reserves, of external help, etc. A leading adept of the "shock therapy", Anders Åslund, formulates in his contribution a guiding principle of this policy with disarming straightforwardness, bordering on simple-mindedness: "The higher an inflation is, the more deflationary is the policy needed to bring it to a halt. The more distorted an economic structure has become under communism, the greater are the structural changes required to put it right. The fewer the market-conforming institutions that exist, the more difficult it will be to develop them" (pp. 233–234).

Yet what about the limits to the feasibility of this policy and what about the human costs to be borne with it? Åslund's answer is: "the worries about social explosions have been pretty exaggerated to judge from the experiences to date. The issue is to pursue correct economic policies rather than make a sufficient number of political compromises...As the systemic changes have proved complex and costly, people in 'latecoming' countries have realized that they are in for a hard ride, and their expectations have proved to be more realistic, thus facilitating social peace...People must understand the implications of the systemic changes so that they can be convinced which of their demands would be unreasonable" (p. 233). However, exactly which of their demands would be unreasonable, indeed? The expectation of a better life in the not so distant future or their everyday needs of food, shelter, heating, medical care, education, etc? How would it be possible to convince them that the latter demands are "unreasonable"?

Of course, the conductors of "shock therapy" may follow the very practicable advice given by *Schüller* and *Wentzel* in their contribution (p. 347): "the opening up of the post-socialist countries permits their citizens to travel to foreign countries. People can see with their own eyes the prosperity and the welfare of an open society. This should increase the acceptance of the temporary hardships of transition and contribute to a general consensus in society". But who will foot the bill of this propagandistic tourism? The population of the post-socialist countries can hardly afford it, for one third to one half of the people live under the official poverty line.

There is only one practitioner of "shock therapy" among the respondents to *Acta Oeconomica*, Marek *Dąbrowski*—the deputy minister of finance during Leszek Balcerowicz's ministry in Poland—who has a much more cautious opinion about the possibility of maintaining a social consensus for a longer time. He emphasizes that "the social coalition in favour of macroeconomic stability is usually not very strong. It seems to be affected by the lack (or the weakness) of a private sector, the lack of a private financial market and of rather limited private savings" (p. 263). Another important detail is that the "political credit for a reform policy and time... is usually given only to the first post-communist government and for a limited period of time... From the psychological point of view it is much better to concentrate most on painful decisions in the first decisive stabilisation and liberalisation package than to make a lot of shocks over a longer period of time" (p. 266).

Thus, if only because of sociopsychological and political reasons, the "shock therapy" is feasible only over a rather limited period of time, not to mention the other obstacles to its successful applicability. (They are also lucidly presented by Dąbrowski).

Privatization, on the contrary, takes time, needs a quite different approach and has different (long-range) aims. Perhaps the only common feature is that both processes need governmental initiation and control, and should be launched simultaneously, if possible, for a number of political, social, economic and other reasons.

All this notwithstanding, the umbrella called "shock therapy" very often covers not only programmes of stabilization but those of privatization, too. Why? Apart from the mere ignorance of the programme-writers and policy-makers—who as a rule are new-comers in their present field of activity—this notion intends to express nothing more than a political will and determination to carry out radical and quick socioeconomic changes. The political sloganeering of this type could be useful during the election compaigns, later, however, it goes sour when it turns out that (a) "until now there has been no definite answer about how to privatise quickly" (Dąbrowski, p. 266); (b) the new institutions created by shock-work can be "empty" ones (Kovács, p. 312) without real functions to perform; (c) the privatization that promised to cure the social injustices of the previous regimes gives rise to new social contrasts and inequalities instead.

The chances for success

The common feature of the present situation in the former CPEs is *the loss of illusions about their quick transformation into market economies and/or their catching up with the advanced industrialized countries.* The above is, alas, an indisputable fact. Despite the loud optimistic declarations of the political leaders both in the East and the West,[6] there is less and less credence among the population of the countries concerned.

There is not much sense now in ruminating on the bases of these illusions, or whether these bases actually existed at all. Nevertheless, there *are* some really unexpected factors and misconceptions which contribute to this disillusionment and to the unavoidable changes in the strategy of transformation.

Two new constraints on the strategy of transformation

(a) The reasons for the *unprecedented severity and probable long duration of the economic crisis* have already been discussed in Section 1. To this we should add an important fact (and one generally ignored by the public)—namely, that the economic decline in some countries of Central and Eastern Europe began before the systemic change, or would have been started independent of it, under conditions of the tottering state socialist economy. (This fact is rightly pointed out by Dąbrowski, Knirsch and other contributors.)

It is also an important fact which should not be neglected, that even under the present depressed conditions—as Jozef van Brabant writes—in some countries "domestic markets are better provisioned and the proverbial queues have gone; external balance has improved considerably, in many cases through sharp export gains in new markets, and new economic activities are mushrooming" (p. 241). Expressing it in more general terms, *the Kornaian resource-constrained economies of shortage have turned, or are turning, into demand-constrained ones*,[7] even if this conclusion is more or less valid now for the former CPEs of Central Europe (Slovenia included) only.

The fact that these really positive changes have been achieved, and the unexpectedly high price paid for them by the societes of the former CPEs, should lead to a shift in the priorities of transformation policy. One cannot but agree

[6] A good example of this seemingly obligatory official optimism appeared on the day these lines were written. Vladimir *Dlouhy*, minister of industry and commerce of the Czech Republic informed the mass media in Vienna that his country would be ripe to join the European Community within two years. (NAPI, Budapest, January 25, 1993.) This statement was perhaps intended to calm public opinion after the break-up of Czecho-Slovakia.

[7] This fact was duly noticed by the experts of the UN ECE. See ECE (1992), p. 53.

with Hans-Jürgen Wagener, who suggests the implementation of various measures which will be conducive to growth and not directly to the transition from plan to market. "Given the firm intention to install a social market policy in countries of Eastern Europe, and given the necessary initial constitutional decisions including the decentralization of economic decision-making (corporatizing state firms before they can be privatized for instance), it is success with economic growth (that) will stabilize and speed up systemic transformation" (p. 369). It is hardly incidental that similar suggestions can be found in many of the other contributions, if not the majority of respondents to *Acta Oeconomica*. This includes those experts who were, and perhaps still are, staunch followers of the neo-liberal school of thought.

(b) Perhaps an even stronger factor which is causing disillusionment is *the widespread feeling concerning the insufficiency of actual Western aid*, particularly if compared to the expected or—allegedly—promised help of similar scope to that of the Marshall Plan. It can be left to the historians to find out whether such commitments really had been made by the Western politicians and what their precise content was. Though certain promises have no doubt been made, and indeed are still being made (everybody can hear or read various public statements of this kind), it has now become clear that both the Western politicians and their eager audience *have fallen victim to a kind of self-deceit*.

The political leaders of the East are ready to blame the West for not having a consistent strategy concerning the changes that would come and/or are already going on now in the CPEs. Though this complaint is true, it partly misses the point—namely, whether it would have been possible at all to have a coherent strategy adequate to cope with the situation that has really emerged. The "situation", i.e. the total collapse of the state socialist system and the Eurasian military bloc which occurred under normal (i.e. peaceful) conditions could neither have been forecasted nor imagined by anyone. Also unpredictable and unexpected was the acceleration of the process which started in 1989. In the middle of that year it was quite possible to foresee—with a high degree of certainty—the accomplishment of a systemic change in Poland and Hungary and also their breakaway from the Eastern bloc. However, towards the end of the same year this had already been happening all over Central and Southeast Europe (except Yugoslavia and Albania). And two years later neither the Warsaw Treaty and the CMEA nor the Soviet Union itself existed anymore. For such developments no scenarios could be worked out in advance.

It is much more difficult to give a definite answer to the question whether the West *could* have had a coherent strategy at all concerning the treatment of processes of decomposition ongoing in the Eastern bloc. The root of the matter is *the asymmetry of the political and economic interests of the West vis-à-vis the East*.

While throughout the whole post-war period the main axis of world politics was the East-West military confrontation, and thousands of billions of US dollars were spent on it by both sides, the economic power and the world market share of the countries of the now defunct Eastern bloc, as well as their economic attractiveness for the outside world, were relatively weak at all times. This has remained the case up to the present day. Towards the end of the 80s their share in the volume of world trade amounted to some 7 or 8 percent; a component of this was their share in the foreign trade of the OECD countries, which was a mere 2–3 percent. There were no foreign direct investments in the region—due to the nature of the system. (However, a considerable sum of debts owed to Western banks and governments had been piled up in the region, and because of this they had a real interest in the prompt collection of debt services.) All in all, the economic importance of the region for the West has been a *quantité négligeable*.

From the asymmetry of the economic and military interests of the West a number of contradictions followed. Here are some of them:

— During the period of military confrontation the western governments rather skilfully used the economic carrot-and-stick policy vis-à-vis the particular countries of Central and Eastern Europe. While doing that, they pursued exclusively the aims of their military and political security by trying to loosen the ties of one or another country to the main enemy—the USSR. This is why the main recipient of American grants, credits and other preferences for a long time happened to be Poland (even during the hardliner Gomulka and Gierek regimes), Romania in the years of the brutal dictatorship of the Ceauşescu family, and at a very late stage Hungary—the only country that started real reforms. As the economic aid served the interests of the international military strategy, the end of military confrontation led to quite paradoxical consequences. Due to the fact that the Soviet military threat first lessened and later ceased to exist, and the Soviet troops then left or are planning to leave Central Europe, the Western interest in this region *has not increased but, on the contrary, it has lessened*. It is a logical outcome of the changed objective situation; the present governments of Central and Eastern Europe, which originate largely from the former opposition to communist regimes, neither could nor can see this factor distinctly when lamenting about the non-realization of Western promises (or rather their own rosy dreams).

— As the disintegration of the Soviet Union raises security risks and uncertainties it is quite natural that the attention of the West should once again turn towards it, and away from the relatively stable and militarily weak Central European area. As a result, the rather scarce quantities of official aid are now promised to be rechanelled towards the area of the higher security risk. (However, as is well-known, the realization of even these modest promises is permanently delayed.[8]) Now, as in the past, it is not the criteria of economic efficiency or trade promotion

[8] It seems that the new administration in the USA is not going to change this course of conduct either. According to *The New York Times* (February 8, 1993) the Clinton administration considers the future of Russia to be the most important national security problem but for the time being

which govern Western aid, but the perceptions of the real or potential threats to military security. In this "competition" for Western attention the Central European area falls behind the other parts of Eastern Europe. Of course, if the developments in the post-Soviet successor states change for the worse—i.e. anarchy spreads, new dictatorships emerge or new military conflicts break out, etc.—the strategic importance of Central Europe for the West could be upgraded again. Under these hypothetical conditions something like a new edition of the one-time *cordon sanitaire* might emerge. If this is so, the paradox is that *the western support to Central Europe will improve when its international environment worsens.*

— For the political elites of the Western world it is obvious that the socio-economic transformation and the macroeconomic stabilization of the former CPEs needs direct and indirect financial aid from the developed industrialized countries. The latter should give it because basic Western interests are involved. To realize this help the western mass media are waging what is almost a kind of "brainwashing" campaign. There are not only former "doves", but also former "hawks" such as the "father of the H-bomb", the nuclear physicist Edward Teller, or Mrs. Jeane Kirkpatrick, former ambassador of the Reagan administration to the United Nations, who now speak up for massive aid to be given to the former enemy countries. The same can be said about the western respondents to the *Acta Oeconomica* questionnaire. Those of them who deal with the issue see the Western aid to be an indispensable condition for the successful transition of the former CPEs to market economy. It is particularly true for the "shock therapists" (i.e. the proponents of a quick transformation process), as its costs are very high. Yet once again a kind of schizophrenic attitude characterises the behaviour of the main international financial decision-making bodies like the G-7 group, the IMF, etc. While preaching the virtues of "shock therapy" they withdraw or limit their financial aid, trade concessions just at the most critical moments: namely, when the restrictive economic policies are beginning to make progress. This has happened in the case of Poland, Hungary and some other countries.

The enlightened view of the Western political elites notwithstanding, the chance for acceptance of a large-scale aid project is smaller than ever. The main reason is not an economic one but political. *It is precisely because the war threat is diminishing that public support in the West for an aid policy that can solidify peace is also diminishing.*

This phenomenon may be surprising for the inexperienced new leaders of the former CPEs. They perhaps were uninformed about the almost forgotten fact that it was the "red scare" only that made the now much-celebrated Marshall Plan acceptable to the American taxpayers in 1947–1948. At that time the "red threat" was not imaginary, at least not in Europe. Nowadays this threat is diminishing,

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does not intend to boost the financial support of this country. (Reported by *Magyar Hírlap*, Budapest, Febr. 9. 1993) and this fact—again in a paradoxical way—limits the power of governments to dispose of taxpayers' money. Being compelled to afford only modest cost-saving aid programmes they are trying with good face to convince their Eastern audience that it is better to study how fish than being given fish itself. (These were favourite parables preached by Mrs. Thatcher and President Bush during their visits to the eastern part of the European continent.) However, if some countries already have some "fish" for sale the West is busy preventing them from selling it. (See the cases of Eastern exports of agricultural goods, textiles, steel products and other "sensitive" goods.)

The possible shifts in the strategic priorities of transition

Constrained by the two unexpected or unforeseen factors—the severe depression and the absence of a non-debt-creating inflow of resources (foreign direct investments have up to now been substantial only in Hungary and in the Czech part of the former Czecho-Slovakia)—the process of transformation of the former CPEs should be reshaped and some earlier concepts rethought. From the contributions to *Acta Oeconomica* it emerges that the following crucial issues need to be revised.

a) The anti-crisis policy and the stimulation of economic growth

This might be the most sensitive issue for the whole strategy of transformation still rests on two fundamental principles—macroeconomic stabilization by means of a deflationary policy and economic liberalization by means of destatization (privatization, deregulation, etc.). The leaders of the new democracies should follow Bismarck's maxim: "Politics (in our case—economic policy) is the art of the possible, the attainable", but perhaps even more the version of this saying updated by John Kenneth *Galbraith*: "Politics is not the art of the possible. It consists in choosing between the disastrous and the unpalatable." In their suggestions the respondents to the questionnaire tried mostly to follow the Galbraithian interpretation of the famous maxim.

We have already referred to Hans-Jürgen Wagener, who sees the revival of economic growth as main priority of economic policy at the moment. But how is that to be done? Jan *Winiecki* warns that the kind of output fall which was caused by the unavoidable adjustment of enterprises to the real market conditions "cannot be remedied by increasing aggregate demand" (p. 371); the budget constraint should remain hard and the institutional restructuring (e.g. of the banking or tax system) should continue because it is conducive to economic growth too. It is important to note that Winiecki, while insisting on the continuation of economic restructuring, outrightly rejects "treating the economy in a neo-classical manner" (p. 375) and proposes a complex of measures that deal with unemployment and other schemes of social policy.

A similar reasoning can be found in van Brabant's contribution. He writes about the danger of establishing a "low-level equilibrium trap" in an environment with substantial under-utilized capacities (p. 241).[9] According to him "economic stabilization is a must before any serious restructuring of economic policies, institutions, instruments, and behaviour can be contemplated in earnest... But stabilization should not be seen as an end in itself, however useful it undoubtedly will be... successful transition requires laying as rapidly as possible the microeconomic foundations for macroeconomic stability and sustained progress toward economic prosperity" (pp. 241–242). As the sizable inflows of foreign capital needed in order to revive and restructure economy have not materialized, the only possible way forward, according to him, is through a more evolutionary transition without abrupt shock treatment (i.e. on the "Hungarian path first laid under communism", as he calls it). This will enable the establishment of the institutional environment required by market economy. While almost all his advice is rational, none of it indicates an easy way out of the "low-level equilibrium trap", and especially not in the short run.

b) Transformation and social consensus

Because of the optimistic expectations and promises of the prevailing neo-liberal blueprints of transformation, social consensus was simply a non-starter in the debates at the initial stage of systemic change. Under conditions of firmly established mass unemployment (in some former CPEs) or its inevitable coming (in others), after a long period of declining living standards and sharpening social contrasts, the problem of maintaining a social consensus has become an issue all over Central and Eastern Europe.

As the programmes for quick and relatively painless transition to a prospering market economy (supported by the massive foreign aid) have failed, it is quite natural that most experts envisage a gradual and socially difficult transformation that will spread across a rather long period; thus they put the problem of social consensus at the forefront of a successful policy.

[9]It reminds us of the description given by *Keynes* to the situation in the years of the Great Depression: "it is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable. Indeed it seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse" (Keynes 1936, p. 249).

Among the contributors to the *Acta Oeconomica* inquiry not only the critics of the neo-liberal school of thought—like Andreff, *Dallago* and Knirsch—but also many others deal with social consensus. It is very remarkable what Márton *Tardos*, one of the leaders of the Hungarian liberal Alliance of Free Democrats (and its leading economic expert) writes in his contribution. Instead of routine cursing of the evils of state socialism, Tardos—rather surprisingly—stresses those features of the sociopolitical legacy of dictatorial socialism which are difficult for the new-born regimes to emulate. He enumerates such things as raised standards of living, ensured full employment, fair distribution of goods and the fact that "countries... of the Central-East European region were able to create some significantly advantageous conditions, even when compared with those prevailing in the free world" (p. 348). (To the present author the latter statement seems a bit exaggerated. Tardos probably extends conditions that really existed only in reformist Hungary or Yugoslavia to the whole region, but that is hardly acceptable.)

Anyway, what is important is the author's honest admission of the (real or expected) negative consequences of the post-communist transformation. Namely, that neither full employment, nor equal conditions or even equal starting chances can be ensured for the population. Alongside this, the crucial point made by Tardos probably touches the heart of the matter—i.e. the prospects of the whole transformation process and particularly the fate of the neo-liberal strategy of this transformation. Tardos writes: "Perhaps the most shocking feature of the unavoidable decline of the standard of living is the emerging crisis of the public services in the post-communist period... the newly developing weak regimes (in any event, weaker governments than former ones) are not capable of concentrating the budgetary revenues necessary for the operation of the system of redistribution which had been functioning for decades... The inevitable consequence of the state budget's crisis is the decline or cessation of subsidization of the individual branches of the economy. Furthermore, there is a dramatic decline in the quantity and quality of public services" (pp. 349–350).

This point is crucial, because the simultaneous provision of public services (health, education, etc.) on an adequate level, and the radical reduction of the budgetary expenditures for these purposes, look like the problem of squaring the circle:

1. If the public services are curtailed, the social support for any government in power will go, because the widest strata of population cannot and will not be able for a rather long time to afford the payment for the costs of these services from their personal incomes. The level of the incomes inherited from the socialist system did not cover from the outset (since the World War II) the costs of such services paid for by the state.

2. If a government is not able to cut public services (because this would undermine its own power position) and maintains more or less the same level of spending, it would actually mean giving up the programme of destatization, lib-

eralization of the economy and renouncement of its intention to cut down the redistributive activity of the state.

For a liberal party both alternatives would mean abdication of present or future power.

What does Tardos propose? In fact, to eat the cake and to have it as well. On the one hand, "budgetary expenditures must be reduced" (health, education, etc. including); on the other, "municipal, cultural, social security and health institutions must be involved in privatization" with "tax preferences offered to the public investor". Also, "positive help has to be offered (by whom?) to the strata of the newly poor, who will suffer serious losses in the process of the transformation" (pp. 351–352). Actually it seems that according to Galbraith's maxim, Tardos, as a genuine politician, chooses the unpalatable to avoid the disastrous.

However, to secure the necessary social consensus for the transition to market economy, it is not only the problem of financing the so-called safety net that has to be solved somehow. The process of privatization, and the creation and functioning of a competitive market economy produces and reproduces various social inequalities (in income, wealth, social power and prestige, etc.). The new social order will be legitimate if the new inequalities become socially acceptable (cf. *Hillman*, p. 287). (Let us not forget that the hierarchical social order of state socialism was not egalitarian at all. However, its inequalities had a different, less conspicuous, and even concealed character, and were legitimated by the ubiquitous and rather sophisticated ideology).

How can the social acceptance of the emerging inequalities be achieved? Tardos clearly sees the difficult character of this task being aggravated by the fact that the new class of proprietors very often obtains its fortune by means that are not quite legal or honest. "Their behaviour... produces a great deal of antipathy in wide circles of society towards the future middle classes and the truly wealthy people, who are supposed to constitute the foundation of the new order" (Tardos, p. 351). But what kind of solution does he suggest? It is not clear, at least not in his present contribution.

It seems, that no effective solution can be found that is based on the neoliberal ideology. Perhaps it is not accidental that while *Tardos* accepts the idea that the emerging society "is not capable of creating equal conditions for the population, and this inequality starts from childhood" (p. 349), Arye L. Hillman sees the justification for this economy in quite an opposite tendency: "While a market economy does not promise equality of income and wealth, it should provide equality of opportunity" (p. 288).

Some authors (*Kramer*, Winiecki, Dallago, Wagener) point to the need for *stability and security*, both legal and social, provided by the state, trade unions and other institutions of the *modern* industrial society and forming the basis for social consensus. This society is not essentially that of a free market but of a mixed economy regulated by mutual social contracts and obligations for the social partners involved. Besides the higher living standards perhaps it is this kind of social stability which can make the new social inequalities acceptable to the transforming societies of the former CPEs.

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From the controversies discussed here one can conclude that the chances of modernizing the countries of Central and Eastern Europe, and the possibility of their catching up with advanced industrialized societies, depends not simply on the accomplishment of privatization and/or marketization of their economies. It depends much more on what kind of market economies will be established—those which existed here and elsewhere in the last century and up to the interwar period, or those which have evolved and readjusted themselves to the changed social conditions of the Western democracies during the last half century. The present dramatic situation in Central and Eastern Europe was caused mainly by its isolation from this process of socioeconomic change. One can only hope that this drama will not turn into a tragedy.

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SOCIAL EFFECTS PRODUCED BY THE SYSTEM CHANGE

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The socio-economic effects of the system change are unequivocally demonstrated in the survey. The view that the political system's change was not followed by the system change of society and economy is not fully acceptable. The changes may be deemed too slow but they have certainly started. In the analysis undoubtedly negative tendencies are pointed out, however, in its totality, it must be said that the widespread despair which is exhibited by public opinion research in Hungary is not justified. The system change is in progress,—true, from many aspects, slowly, but without traumatic shocks and without mass sacrifices.

Our study examines some of the social effects produced by the change of system which took place over the past two years. Probably both experts and public opinion agree that the change was accomplished first of all on political level; namely, free parliamentary elections were held, the one-party political system was succeeded by a democratic multi-party parliamentary system, and the institutional and legal frameworks of politics were established. At the same changes in the socio-economic system seem to be proceeding at a much slower rate than change in the political sphere. Changing into a market economy and carrying out privatization are still subjects of professional debate rather than practices based on consistently elaborated concepts and laws. What is more, while these processes have had a halting and poor start, society has been stricken by several "unavoidable" concomitant side effects, such as unemployment and increasing income differences.

Based on all this, it is no surprise that—according to a Gallup poll—in early 1991 the Hungarians were the most pessimistic people in Europe about future prospects; and that—based on Szonda-Ipsos[1] research—80 percent of the population feels that its material situation is worse than it was a year ago and merely 5 percent mentioned some improvement. It is also a general conviction that in the past period impoverishment of the population was extremely accelerated.

In contrast to these popular beliefs research concepts are currently being formulated about how a bourgeois middle class can be created, how a "continuous deep social structure" survived the decades of an anti-bourgeois regime, where the "old-new" citoyens and entrepreneurs come from, whether the domestic bourgeoisie will be a national one or a "comprador-type" and finally how a change of the elite will take place in Hungary.

One might argue that this is another example of experts and society ignoring one another. We would argue that there is some interchange between these groups as various programmes are still being drawn up to cope with unemployment and to

[1] A private institution for public opinion research (ed. note).

restrict the growth of social inequalities as was the case earlier. Nevertheless, it is still very important to probe citizens' emotions as to the actual processes, so that our knowledge of reality will not only be built on the opinions reflected by public opinion polls. In our study we will examine two such social processes in the period of the change of the system: a special "intragenerative" mobility, in which certain social groups started from a position of state employment and moved towards a more independent entrepreneurial position or more autonomous employment and the development of income inequalities, specified by strata, with regard to both individuals and families.

In our analysis we are going to rely on the data of two empirical surveys, from the survey series carried out by the Social Research Informatics Centre (in the following: TÁRKI).[2] These allow us to examine the current occupational and income situation of a group about which we have earlier data. The two points in time in which our data were collected are the spring of 1989, (prior to the change) and the spring of 1991. As a result of which, we have obtained information not only about changes which came to pass throughout Hungarian society but also about changes which occurred in the lives of individuals and families, over a span of time starting from before the parliamentary elections (considered the milestone of the system's change) and ending a year after it.[3]

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[2] TÁRKI's survey system is of a panel character. This method is much more effective and reliable for chronological comparisons than if the researchers examine the same question repeatedly using varying patterns of the population. In the case of panel work exactly the same persons participate in the surveys at different times.

[3] The first survey was entitled TÁRKI-B study; field work was carried out between April 5 and May 2 1989, and the second wave of the panel was a survey using questionnaires entitled TÁRKI-E which took place between April 15 and May 6—with the material aid of the TS-3 programme. The data file and documents of the research can be found in TÁRKI's databank.

We could make two further comments with regard to the pattern:

The 1991 survey was conducted on a 1000-person nationally representative sub-pattern of those questioned in 1989. According to sense, those who during the past two years changed their residence, died, or for some other reason could not be reached (pursuing military service, in hospital or in prison) could not be questioned in the second survey. 285 persons were replaced from the 1000-person nationally representative pattern of the 1989 survey in such a way that their major demographic criteria were the same as those persons who were missing. In drawing up a parallel between the data of the 1989 and the 1991 survey, the correspondence in the cases of 21 persons was not unambiguous, therefore the final pattern about which our analysis was made, consisted of 979 persons.

The pattern represented the adult population (the bottom age limit in 1989 was 18 years, but, given the character of the survey, 18 and 19 years old persons could not fall into the pattern of the 1991 survey). Although the pattern well reflects national data, we should still call attention to a few things: In similar types of surveys it is a general experience that those belonging to the highest income group are under-represented in the pattern (most refusals to answer are from this group) and, following from the way of selecting the pattern, the homeless play no part at all among the questioned persons; Owing to the method of panel questioning, only death allows leaving the pattern and joining it is impossible. In the light of these facts we must be careful with our claims regarding the poorest and the richest and have to accept the assumption that the

Theoretical frameworks of the analysis

Although our study is basically a report on the results of our empirical analysis, we wish to briefly summarize our theoretical considerations. We deem this the more important as we feel a distance not only between objectively measured processes and their subjective perception (by the populace) but even between differing scientific analyses of the system change—in both concepts and viewpoints. The same phenomena and problems are differently viewed and explained by the political analyst and by the sociologist working with empirical data and building on statistical analyses. Added to which is the fact that the influence of political sciences on public opinion is presumably stronger than that of empirical sociological research.

Today's social changes and the socio-economic phenomena of the changing system can be neither evaluated nor understood without building upon knowledge about the structure of Hungarian society, accumulated in the decade preceding the political change. However important we may deem the caesurae brought about by events of the past two years, continuous elements have a very strong influence on our society. Of these continuities, we think the double character of the social structure described by the L model of T. *Kolosi* (1986) or by I. *Szelényi*'s model of dual triangles (Szelényi 1990a) to be basic. The common thought in both models is that in Hungarian society a "socialist mixed economy" coexists with a redistributive and a market hierarchy. Even if (by the gradual gaining of ground by market elements) this duality is gradually altered with regard to both its proportions and trends, distributive elements will obviously be present for a long time and their role will also be very likely a greater one than the measure of state intervention is in every industrialized civil society, where it is obviously necessarily present.

This social structure generates and/or preserves such interest relations and attitudes, as the "on the top" central statism, and "below" paternalism which restricts a faster implementation of ownership reforms and hinders the unfolding of autonomous societal organization (ie. the mobility from the redistributive economy towards a market-oriented one). With regard to the statement on paternalism, even international comparisons show that the population today still feels a greater need for state participation in solving socio-economic problems (e.g. income inequalities or unemployment) than do people living in western market economies (Kolosi 1990).

Some, (often politically articulated) questions emerge—such as changing of the elite, the achievement of bourgeois/middle-class status,—as special manifestations of social mobility. We may refer to Pitirim *Sorokin*, who deals with parties and other political organizations as some of the channels of mobility (Sorokin 1959), particularly stressing that—similar to the role of the army in wartime—this mo-

population's mobility or immobility in connection with residence is influenced by the change of the system.

bility channel plays a small role in stable societies, while in periods of political transformation it grows more significant.

An international comparative survey covering Hungary, Czechoslovakia and Poland, which focuses on circulation of elites considers one of its theoretical guiding points the so-called FJH hypothesis which is today one of mobility research's most fashionable theories (*Szelényi and Szelényi* 1991). According to this, no significant differences were shown in pure mobility as a measure of the openness of society, among countries with different social orders (*Featherman, Jones and Hauser* 1983). While this theorem is criticized by many West European mobility researchers (e.g. *Erikson and Goldthorpe* 1983), the question for the sociologist is, with regard to our region, to what extent the FJH hypothesis is true in an area where not only economic transformation and modernization process have taken place but a change of political systems as well.

Another widely discussed question is what chance is there for a revival and development of a bourgeois middle class in Hungary. As T. Kolosi (1991) feels, here the development of the future relationship between *Besitzbürgertum and Bildungsbürgertum*, (i.e. between the proprietor and the qualificational bourgeoisie) is at issue: namely, how much space will be allowed the "old-new" entrepreneurial stratum by the intellectuals. On the basis of historical experience the opinion of J. Szelényi (1990) is that the distinguished role held by intellectuals now is only transitory.

However, it must not be forgotten that in Hungary, even among the intelligentsia, material interests are dominant over post-material ones. This was indicated by the surveys of E. *Hankiss* and his co-workers in the early eighties (*Hankiss, Manchin, Füstös and Szakolczai* 1986) and this is also reflected by the data of the Inglehart test repeatedly made by TÁRKI in 1990. As a result of this, the intelligentsia is rather "frustrated" by the relative wealth and enrichment of the proprietary bourgeoisie arising from the market and by the fact that this stratum, following its basic materialism, exhibits provocative consumption.

Moreover it is obvious that there are also mobility aspects of where this bourgeoisie to-be is recruited—who is mobilized from the redistributive sphere of society towards the market sphere. This kind of mobility (the technical term for it is *intragenerative* mobility) means a motion within one's career. According to occupational mobility surveys, this mobility within a generation is usually of a lesser degree than that between the generations; e.g. mobility compared to the position of the father. What is more, in Hungary in recent decades intragenerative mobility slowed at a slightly higher rate than intergenerative mobility did (*Andorka* 1982; *Harcsa and Kulcsár* 1986). The reason for this is that Hungarian society came into an increasingly consolidated condition in the past two decades as regards economic restructuring. Following the change of the political system however, in the course of the gradual arisal of various elements of politicizing and of the market economy, the growth of certain types of intragenerative mobility could rightfully be assumed.

It is, of course, very difficult to foretell, in what proportions these "certain types" of mobility will appear in the process of developing bourgeois civilization. Today we do not know, after the prospective building of privatization and a market economy what share of mobility will be said to belong to the cadre bureaucracy which is attempting to turn its political power into economic power. How much will belong to the "comprador intelligentsia" (Szelényi's expression) arising from state employees or employees of some Hungarian-foreign joint venture, or to the national proprietor bourgeoisie, arising from small-scale venturers or the participants of the second economy is unknown. It is probable that in this process the use or conversion of various capitals, in the Bourdieuian sense, will play an important role. Mobility analyses of the 1980s have shown that in social mobility (or immobility) cultural mobility (or reproduction) played the greatest role (*Róbert* 1986; 1987).

The result of all this research was related to a social situation where other ways of hereditary transmission of advantages and disadvantages were, owing to social structure, strongly limited. These limitations, in turn,—in harmony with the broadening possibilities of working and earning in the second economy—gradually decreased from the early seventies on. In the future, during the introduction of the market economy and ownership reforms, the thesis concerning the outstanding role of cultural capital in the process of mobility must be reviewed in another "field".

In addition to occupational mobility, mobility with respect to income and material situation has to be mentioned. The questions regarding enrichment and/or impoverishment, (i.e. the increasing material inequalities) are permanently on the agenda in empirical sociology as well as in public opinion research. TÁRKI's respective analyses do not indicate movements of great extent in this sphere (Kolosi 1989; *Szántó and Tóka* 1990.). In contrast, other researchers see the phenomena of impoverishment as much more serious and more extensive (e.g. *Szalai* 1990) than we.

One thing is sure; P. Róbert (referred to earlier) when analysing the process of social mobility, found a non-negligible degree of *inconsistence* (in the various dimensions of inequalities the trend and/or degrees of movements are different), under our present circumstances, occupational and material movement is *consistent*.

Mobility towards a proprietor bourgeoisie structure is accompanied by attaining a better material position, while those who become unemployed, obviously and consistently move into worse material conditions. Moreover, it may also be presumed that by the broadening of the market economy, an immobility in the redistributive sphere will also be connected with a relative worsening of material situation. Hence, under the circumstances of the changing system, immobility is not a "neutral" category; those who do not want or are unable to "take the historical opportunity", may easily fall among the losers.

Enterprising and mobility 1989–1991

In the complex process of Hungarian socio-economic transformation it may be obvious to everyone that some will (in the short run) come well, while others will be less fortunate. There are and will be transitory winners and losers. In such situations people, to some part, are palsy-stricken, helplessly watch, and let themselves be whirled along by events. Others, however, more dynamically try to influence events around them. The sociologist speaks about intragenerative mobility, and about the necessity and ability to achieve it, while the man on the street feels only that he "ought to start moving."

TÁRKI's data allow the analysis of mobility on two levels: on the levels of ambitions and on that of facts. In a 1988 questionnaire we asked the question "*Would you be glad to be an entrepreneur?*"[4] At that time every fourth person answered yes. By 1990 the ratio of the positive answers reached 44 percent.

The interrelation of the willingness to be an entrepreneur with social-demographic criteria was similar in both cases. Accordingly, men, the younger and the more educated; intellectual workers and skilled workers seemed to have a more entrepreneurial spirit. About half the young people are attracted by the thought of entrepreneurialism but sex is more determining than age. An entrepreneurial desire is stronger in middle-aged men than it is in young women. With regard to education and occupation, semiskilled workers and "routine" white-collar workers are the least willing or able to be entrepreneurs.

Furthermore, it is typical that potential entrepreneurs are recruited from higher income groups, which indicates that people are well aware of the capital-intensiveness of business. The majority of those inclined toward entrepreneurialism would like to start some handicraft or retail trading service, but many would be engaged in animal breeding, plant growing or in some other agricultural activity. Besides these a relative minority consists of those who would pursue enterprises in intellectual services (e.g. opening a design office, or some educational enterprise). Those who do not want enter business refer primarily to personal causes or justify their standpoint by some deficiencies of constitution "it is not for me" or "I am too old", "I am ill". In relation to these the ratio of those who refer to a lack of capital, to taxation or other economic circumstances, or to some former negative experience was low.

During the questioning repeated in 1990, in which those questioned were the same as two years before, the proportion of those willing to pursue business doubled, while no essential change occurred in their composition. Of those answering "no" in 1988, 33 percent now said "yes", while 22 percent of those who were earlier willing,

[4] The analysis of the question regarding the inclination toward entrepreneurialism was carried out by Gy. *Lengyel* (1989); here we only refer to his most important findings and to some results and chronological changes on the basis of the repeating of the question in 1990.

changed their minds. At the same time, more than half of those (54 percent) who were uncertain in 1988 declared in 1990 that they would become entrepreneurs with pleasure.

In the latest survey, in the summer of 1991, we no longer asked about "dreams", we asked only for facts. The question was: "*Nowadays more and more people are working with non-state-owned companies. Have you or somebody of your family tried some of the following things*?" The question was followed by a list. Based on this, in 12 percent of the families there was someone who started some individual enterprise and in 8 percent of them there was at least one person who had started some family enterprise. Most of them tried only one thing but there were a few who had made more attempts. Hence, in the total of individuals and families (family meaning consorts and children) 17 percent had made some attempt.

Who are these entrepreneurs?—Is the obvious question. In the first approach we looked for the answer using customary means of sociological and demographic analyses: whether the entrepreneurs were men or women, old or young, and what their occupation and education was.

It can be stated that men and the young were most likely to have tried to be entrepreneurs. With regard to age the proportion of entrepreneurs evenly decreases as we proceed from youngest to the oldest. From the aspect of qualification: the uneducated, who completed at most 8 primary grades, were entrepreneurs at a lower than average rate. Skilled workers were somewhat overrepresented, as were those having secondary-school or academic diplomas. Regarding occupation, those having autonomous occupation showed an outstanding extent, which is rather obvious as many of them became independent precisely by becoming entrepreneurs. Semi-skilled and unskilled workers were below the average, while a somewhat higher percentage of skilled workers had made attempts. Intellectuals and especially leaders were overrepresented. The data seem to confirm the general opinion that the new forms of economic activity have created a favourable environment for the old economic elite: for managers.

Our survey allowed us to make a comparison between the occupations of those questioned in 1989 and those questioned in 1991. We distinguished between four types of occupational mobility: upward mobility was if someone went from being a physical worker to being a top leader, medium leader or intellectual (4 percent of the pattern); downward mobility was if somebody went from being in an intellectual occupation to being a physical worker (2 percent of the pattern); becoming independent (also 2 percent of the pattern); finally, immobility, including those cases when someone was mobile within the sphere of physical or intellectual occupations (92 percent). (The immobility ratio seems to be very high, but it must be taken into account that we also considered intragenerative mobility process within a time span of two years.)

The social and demographic characteristics in the mobility process show a picture similar to what was exposed in the case of entrepreneurialism. Mobility is higher in the cases of men and the young. Viewing it from the aspect of education, upward mobility is mainly characteristic of those having a university diploma, while independence was primarily the mobility path of skilled workers. It can clearly be seen that in the lives of those in question mobility and enterprising were interdependent events. Those who made attempts at some kind of entrepreneurialism were simultaneously mobile.

The third cross-section of our survey, following entrepreneurial and occupational mobility, referred to the type of workplace. We expected an answer from those concerned to the question as to what the type of the workplace was where they were working in the spring of 1989 and two years later, in spring 1991. The data show that the proportion of those employed by all forms of traditional, redistributive employers (state institutions, budgetary bodies, state-owned enterprises, traditional cooperatives) decreased by 3–6 percent, while the number of those working in other types of market-oriented organizations grew. If we concentrate on "sectoral" differences, we can state that the ratio of people working in the private sector increased from 14 percent in 1989 to 28 percent by 1991, hence the share of those working in the private economy doubled. The greatest growth was observed in the cases of limited liability companies but a significant change was also observed in stock companies, joint ventures and unions. (Of course, here we cannot distinguish actual personal mobility from cases in which the form of the employer's operation changed.)

For social-demographic analysis within workplace mobility we have distinguished three categories: immobility (87 percent of the pattern); mobility "within the sector" (e.g. among state institutions and state companies or among non-traditional employers—3 percent of the pattern) and mobility "between sectors" (i.e. from a traditional employer towards some entrepreneurial employer—10 percent of the pattern); movement in the opposite direction happened merely in a few cases in the survey. In conformity with the above, here we again find that men and the younger are the more mobile—up to the age of 40 in both types of workplace mobility, and between 40 and 50 years of age in mobility "among the sectors". In the latter case probably the operating form of the employer changed and the former company's managing director became the manager of, say, a joint venture. This is also supported by the fact that among intellectuals and leaders the inter-sectoral mobility is higher. Among physical workers mobility "within the sector" is more characteristic. This means that physical workers mostly change their work, while the intellectuals, and especially leading executives, transform their employers. Otherwise, the two phenomena are by all means interrelated. Workplace mobility is much higher with those who also started some kind of enterprise.

In this part of our study we have laid stress on the question of to what extent people seek for alternative occupational and subsistence solutions in the course of socio-economic transformation, and grasp the opportunity of the changing of ownership relations. Our data indicate that, as a result of the changing system, the most significant change came to pass in the company structure of the economy. This is expressed not by the very significant growth in the number of economic units, but, parallel with it, by the great growth in the ratio of those employed in the private economy. In our days 30 percent of active earners are already working in the private sphere.[5]

In this context it is interesting to recall another 1989 TÁRKI survey conducted on "labour orientation" for an international comparison. In this framework the person who received the question, "had to advise a young person" where to go to work. A relatively high proportion (40 percent) of the answers "recommended" not being an employee but to be a private entrepreneur instead or to work for a private employer. This non-negligible "minority", of course, looks at the entrepreneurial and market oriented sphere "in the light of materials". Obviously, people see the difficulties facing "conventional" spheres of the economy, (traditional state employers) and that the sectors suffering a crisis, cannot, for the time being, offer their employees attractive prospects. Despite this only a narrow minority actually made attempts to enter private employment or become entrepreneurs.

The losers and those coming down

In the midst of the economic changes going on in our society the processes produce winners and "non winners" as well as losers. The unemployed and those afraid of becoming unemployed, can be counted as losers. In the course of our surveys we recorded not only "positive mobility" between 1989 and 1991, but also cases of "negative mobility", such as those who were unemployed during the two years. 6 percent of the active earners were unemployed in this period.

Though only a few representatives of the hundreds of thousands of unemployed fall into the pattern of a survey including 1000 persons, there are still some indirect tools available which enable us to determine who the jeopardized groups are. Since 1982 the question of whether the respondent is threatened by the danger of being dismissed repeatedly figured in surveys. According to our data 1989 can be considered the year of negative change with regard to the fear of being unemployed. Between 1982 and 1986 the fear somewhat diminished, always staying

[5]According to the data of the Stratification-model survey in 1982, three quarters of the population participated in the second economy, as well as the state sector. Of this 25 percent pursued only subsistence farming, 3–4 percent were independent, and about half of the earners possessed, (beyond their full-time job), some other source of earning (Kolosi 1987). Though in the present survey no question was put to this end, we assume that the proportion of those pursuing subsistence farming has not changed. At the same time the present data indicate that somewhat more than a quarter of the earners has, beyond their full-time job, some other source of income. The other half of the former "second economy members" entered the private economy in a full-time job, a part of them as entrepreneurs, another part as employees.

below 10 percent. By 1989, however, it had grown by 10 percent and approached 20 percent. By 1991 it had increased by 30 percent and in our last survey almost half the people questioned were afraid of being dismissed.

With regard to this fear there seems to be no difference between men and women. Studying it by ages, in 1982 those between 18 and 30 years were most afraid of unemployment, between 1986 and 1989 they were the most confident, but by 1991 they again felt themselves among the most jeopardized. As far as possible, the position of the 50–60 years old group was the most fluctuating: at the four points in time when the surveys were made, they were alternately the most hopeful and most pessimistic. It is interesting to note that in 1991 the older age groups were afraid of unemployment to a lesser degree, while the younger ones (18–40 years old) were more frightened.

According to our data, on the basis of school education, only minimum differences can be found in the fear of dismissal. In 1991, however, the more educated someone was, the less he or she feared dismissal. Regarding occupational groups, it is the leaders who are the least afraid of unemployment. Moreover, from the mid-1980s on, there was almost no difference between physical and intellectual workers. A characteristic which emerged in this question is that people living in larger settlements feel less threatened than those in small towns.

From those who felt threatened in 1991 we also asked why they may become unemployed. Varying answers could be given to the question. Most of them mentioned "dismissal", the next most favoured answer was "elimination of the company" and the third among the most important reasons was the transformation of the workplace. Today only 16 percent of those questioned think they could easily find some employment, while in the early eighties 45 percent had the opinion that they could immediately get a job and another 29 percent hoped to find a job within two months.

From the data it can also be seen that the population increasingly expects a solution to unemployment from the government. In 1989 52 percent of those answering thought that the government has to provide everybody with work. In 1991 this ratio increased to 74 percent. Hence, while in the period directly preceding the change of the system approximately half the population adhered to a liberal labour policy, experiences of the past two years reduced this side by half, and the "nostalgia" for a state-warranted full employment increased by a significant extent.

The development of the personal incomes 1989–1991

According to the data of our survey real incomes between 1989 and 1991 remained essentially unchanged.[6] Monthly net earnings in 1991 were on the average higher than those in 1989 by a multiplying factor of 1.68 and when examining per capita incomes we found nominal wages and salaries 1.78 times higher in 1991. Since for the whole of the analysed period, the rate of inflation is estimated to 74 percent, the increase of the nominal income was practically sufficient to compensate for inflation.

Beside the unvaried level of average incomes, inequality of the incomes increased at a relatively significant speed. Dispersion of incomes grew from 3700 to 8900 forint, in which, of course, the rising of incomes due to inflation also played its part. Therefore, increasing income inequalities can be better shown if we calculate on the basis of "deciles". In this case we divide the population by tenths of income and examine how many times the average income of the 10 percent having the highest income is higher than that of the 10 percent with the lowest income.[7]

This index number increased from 5.03 in 1989 to 6.01. If we review the past decade, according to the 1982 survey of the stratification model, this index was 5.1, according to the survey of the Central Statistical Office in the same year it was 4.2 and, according to the survey in 1987 it was 4.9. In the 1982 survey of the Statistical Office the incomes of the highest income groups were strongly underestimated, so we may say that in the 1980s the growth of income inequalities was rather modest—in the past two years, however, it accelerated. We can observe similar tendencies if, disregarding the extreme groups, we compare the incomes of the ninth and the second deciles. This index was 2.53 in 1989 and 3.04 in 1991. (In the aforementioned surveys these indices were, 2.7, 2.2 and 2.4, respectively.)

Examining in more detail the differentiation between 1982 and 1989, we experience minimal changes; since 1989, however, the distribution curve significantly changed. From the medium income deciles up, the differences strongly increased: the average incomes in the fifth and sixth decile increased by one and a half, times in

[6] In our survey there was no possibility for a detailed analysis of incomes. Previous sociological surveys proved that income distribution could be approached by some relatively simpler way of questioning. In the research we asked about the net full-time work income of the preceding month and also asked about the most frequently occurring outside incomes. For the sake of correcting the data we also asked whether the respondent made a tax return for the preceding year and, if so, how much the assessable income and the income exempt from taxation was. When questioning in this way we usually get a 20–30 percent lesser income value than in the detailed questions about incomes, but the distribution practically remains the same in both types of questioning. (It is another question that, according to reliable estimations, no type of survey can reveal 30–40 percent of income.)

[7] In professional literature it is often calculated by how many times the share of the lowest decile of the total income goes into the share of the highest decile. It is easy to see that the two computations lead to the same result.

the top decile they doubled. In the tenth of the population with the lowest income the increase by 1.7 (which is typical of the whole population's average growth), can still be observed, whereas in the second, third and fourth deciles the growth did not even reach one and a half times. What follows is that differentiation came to pass in such a way that in 1991 the highest income groups exceeded the average income levels more than they did two years earlier, while a deviation of the lowest income decile from the average did not come about. Meanwhile, the income position of the middle strata, especially of the lower middle, strongly deteriorated.

Now, what does this above described income differentiation mean? In answering this question let us set out from the fact that, besides a stagnant income situation, differentiation may theoretically come about in several ways: 1) the rich grow richer and the poor become poorer; 2) the position of the extreme income groups does not change, the differentiation increases in the sphere of those taking place in the middle; 3) the income position of those in the worst situation does not worsen, while the better position of the higher categories comes about to the detriment of the medium strata.

Our data indicate that in Hungary the third variation has come about. We think this version is in no way the least favourable, especially if we consider that earlier the bottom income decile was already living on the minimum subsistence level and the system of income distribution was limited from above—resulting in a retardation of economic performance. At the same time, this way of differentiation has undoubtedly had the effect of spreading the deteriorating living conditions over a relatively wide strata.

In case we project the changes to individuals, we see that the real income of half the adult population unequivocally worsened (for 7 percent of them it did not even reach the nominal income of two years before) and that for a further 13 percent it was stagnant. Within the one-third, whose income grew 5 percent are those who, throughout the analysed two years, could least doubled their real income.

Hence, the negative public feeling is more understandable, since from public opinion polls it is well-known that even stagnation is usually perceived as a decrease of income, and the comparison with the data of Szonda-Ipsos shows that in strongly inflationary periods the judgement of a slight improvement (within 30 percent) is presumably equal to that of a declining income.

Let us, in somewhat more detail, look at how the income position of the various social groups changed in the two years analysed. The increase in the income of men somewhat exceeds the average, that of women remains slightly below it. From the aspect of age, the income growth of those between 30–50 years of age is the highest, this is followed by the younger men and those over 70, while the income situation of those between 50–70 worsened the most. Private venturers, male leaders and skilled workers increased their nominal income at a rate higher than that of inflation; intellectuals in subordinate posts in accordance with inflation; male semi-skilled and non-skilled workers, subordinate white-collar workers and female leaders increased it below the rate of inflation; and finally, pensioners—especially men—increased it at a rate lagging far behind that of inflation.

The decisive difference can be found between active earners and pensioners. The income position of active earners worsened in 40 percent, was stagnant in 14 percent and improved in 46 percent of the total. The position of however pensioners worsened in 71 percent, remained stagnant in 11 percent and grew better in 18 percent of the total. (In the case of those who were pensioned during the past two years, the situation was almost the same as for those who were pensioners throughout the whole period: the position of 72 percent worsened, that of 7 percent was stagnant and it improved in 21 percent of the cases. Though it is true that with regard to the absolute level, the new pensioners obtain an income higher than the old pensioners do, the deterioration of their income is essentially the same.)

By studying the interrelation between the changing income situation and the mobility from the redistributive sphere into the market sphere, in comparison to the 1.8-times growth of nominal incomes in the cases of those who tried some kind of enterprise the increase in growth more than doubled. More than a two-and-a-half times increase is shown by data from those who became independent, (i.e. who moved from the position of being employees into the private sector). A double income is also characteristic of those who were "upwardly" mobile, hence they also belong to the "winners", though their material advantages are lesser. In the field of workplace mobility those who moved from one sector to another were the most fortunate,—that is to say those who, instead of being a state employee, are now working with some new type of employer.

If we disregard the 2 percent who became active earners in the past two years and examine, by an analysis using several variables, what sorts of social factors significantly influenced income changes over these two years, we find that the active earners—men, people working in private enterprises, or those with higher school qualifications,—increased their incomes significantly—i.e. exceeding the inflation,—and those who, in addition to their full-time job, had some other income source, did as well.

If we look at how the average income of the 1991 income deciles changed at the two examined dates, we gain the impression that if someone had a better income position at the end of the two-year period he or she could achieve a considerably higher rate of income increase. In turn, if we examine how the average income of the 1989 income deciles developed in the past two years, we find much smaller differences. The greatest relative improvement was achieved by those who earlier had the lowest income and the 1991 income position of the lower 50 percent of 1989 is practically independent of the income position of two years before. (The average incomes in 1991 of the lower five deciles of 1989 were practically equal.)

Thus, the most important tendencies with regard to personal incomes were the following: a) real incomes on the average were stagnant, while differentiation of the incomes increased to the advantage of the upper income groups and to the detriment of the medium—especially the lower medium strata; b) those who formerly belonged to the upper income categories have better chances even today to be on the same—high—level, while half of those in the top income decile came to changed position. The majority of them still enjoy an over-average income. Others entering this group also came from groups with over-average income. Hence, from the aspect of income, in the upper regions a significant rearrangement came to pass. c) From those who earlier had incomes below the average, only a few reached the above-average level, but among those below the average level a powerful levelling can be observed. d) The income of half the adult population decreased, and within the 30 percent whose income grew higher, 5 percent more than doubled their income in the past two years.

A good chance for this was given if someone became himself or herself an entrepreneur or, as an employee, from the sphere of the state or of the traditional cooperatives went into the private economy, perhaps preserved his or her earlier leading position, or became a leader because of the system change. e) With regard to occupation, the differences among the layers are small: in all occupational groups the proportions of those whose income situation improved and whose worsened, is approximately the same. Thus, the earlier assumptions according to which either the working class or the intellectuals would be the losers of the changing of the system, cannot be justified. However, the position of the pensioners did considerably deteriorate, be they old or new ones. They were the least able to cope with the effects of inflation.

The development of family incomes, 1988–1990

From surveys on material and income differences it is known that the living conditions of families are determined not by personal but household income. In both of our surveys we asked about the family or household incomes of the preceding year, hence, in this case we compare the situations in 1988 and 1990.

In the case we look at the increase of incomes by households, in 1990 the whole of the household income was 1.44 times and the per capita income 1.5 times higher than it was in 1988. The factor of inflation falling to these two years was 1.5. Thus, the income growth in the totality of households did not reach the inflationary level. However, in the case of an average household, a stagnation of the real income can be observed. (The difference between the total and the per capita incomes is the result of the fact that in the period examined the average number of the household members declined from 3 to 2.8.)

At the same time, in the case of the household incomes no increasing inequalities were experienced. The differences between the two years are within the standard statistical error, therefore we practically assumed that inequalities were unchanged. (We should add that from the 1982 and 1987 income surveys of the Central Statistical Office a similar index can be gained—hence the inequalities in the household incomes can be considered practically unchanged within a decade.) What is more, if considering the detailed decile distribution of household incomes, we arrive at the same conclusion.

We gain a very interesting result if we look at it on the basis of the individual deciles of the two points of time, how the income of each decile changed during the two years. Viewing it on the basis of the 1990 deciles, the nominal household income of the four lower deciles does not reach the amount they received two years before. Thus, according to the household incomes the lower 40 percent of the population—despite the 50-percent inflation of the two years—lived on a lesser income than it did in 1988. On the other hand, however, those who in 1990 belonged to the top 10 percent lived on an income almost twice as high as it was two years earlier, and in the case of a further 30 percent the income growth matched the rate of inflation.

However, calculated on the basis of the 1988 deciles, the rearrangement is highly radical: in the case of the then top decile a considerable decline of the minimum income can be observed while in the lowest income categories a significant increase came about. Obviously the experiences gained in the development of personal incomes does not justify such radical changes. Between the two surveys the connection of personal and family income increased (in the case of personal and household incomes—rather significantly—from 0.54 to 0.68, between personal and per capita income within the household—only slightly—from 0.54 to 0.59), which shows that household breadwinners from the aspect of income became more homogenous, and the role of the children's number in influencing the income position of the family decreased only a little. However, not even this change justifies the radical rearrangement we have found in the decile distributions. Merely 50 percent of those questioned were in 1990 in the same or the neighbouring decile, as two years before; 22 percent fell and 27 percent rose in this relative income index. Only a smaller part of the change can be explained by the income change of the person questioned and of his/her marriage partner, the major part of the change is explained by the changes in the demographic structure of the family.

All this shows that even in the period of the changing system the income position of the families was more influenced by the birth of a child, some member of the family becoming an active earner, a divorce or some other circumstance changing the family structure, a pensioning or a death than it was by the changing income position of individual family members.

We have also made an attempt at reviewing the position of the population living below the subsistence level.[8] According to our estimation the proportion of

[8] We stress the estimation character of the following statements. We measured the survival levels calculated by the Central Statistical Office against data of our respondent for different types of families. However, owing to the aforementioned particularities of given statements on

those living below the subsistence level considerably grew in the period analysed. While in 1988 9 percent of the adult population was living below the subsistence level, this ratio rose to 15 percent within two years. The change is dramatic and is in harmony with our earlier data according to which half the population suffered a worsening of their income situation—this worsening was especially significant in the case of the lower middle class. Thus, it became a reality that those who had lived only slightly above the subsistence level fell under the subsistence level. At the same time we have seen that the poor's fall behind the average did not accelerate. Thus, the social policy of the state was able to prevent the increasing backwardness of the poorest but could not counter-balance the burdens on the lower middle class caused by the economic crisis. Hence, in 1990 considerably more were living below subsistence level than two years before. (To some extent this was also supported by the fact that the values of the subsistence level grew more rapidly than the rate of inflation did. At the same time the views which often appear in the press about a 30–40 percent of the population living below subsistence level do not seem to be well founded and can also not be justified by the data).

Beyond the growing proportion it is especially noteworthy that altogether 4 percent of the population lived below subsistence level before and after the change, and 80 percent never came into such position. Hence, the population living below subsistence level rapidly changes, and is a characteristic of only a small share of the population to remain permanently in a peripheral situation. Thus, the number of those who live close to the economic boundary fall below subsistence level because of some unfavourable event: these people can, however, soon rise from this position.[9]

Conclusion

In our study we have analysed, by using empirical sociological data, two important factors out of the social effects of the changing of the system: namely, occupational mobility and the changes of income situation. The main aspect of

incomes, we were able to estimate the family incomes only with average multiplying factors. Therefore our data concerning those living below subsistence level cannot be considered accurate. Accurate data can only be gained by detailed income surveys. Since in Hungary these are made only every five years, exact data of the population living below subsistence level were obtained in 1987. The most recent publication of the Central Statistical Office (1991) allows itself merely the statement that the population living below subsistence level during the 1980s always remained less than 10 percent. Our calculations also fit, with great probability, with this data. Therefore our estimates can be accepted as having great probability.

[9] The international,—and increasingly frequent—household-panel surveys also arrive at similar results. It was demonstrated first in America that though the proportion of the poor within the population is invariable, only a small part of them is permanently in this unfortunate position (*Duncan* 1984).

our study may be how the "balance" of losers and winners developed in these two dimensions of inequality. When evaluating our results we have to be aware of the fact that in the Central East European region the change of systems was connected with a serious economic crisis, so it was not possible to compensate for the necessary losses of the losers with economic growth. At the same time our data also indicate that there are also winners of the changing of the system, namely, persons who were able to adjust to the new conditions and to switch into the new possibilities provided by the private economy.

The degrees of motions in the spheres of occupation and in that of incomes in the two years analysed were not equal. The sphere of the losers in materials is much broader than the sphere we described in connection with the changing occupational structure (the sphere of those becoming unemployed or being afraid of it). We have to say that almost everybody who did not take hold of the new opportunities is for all purposes a loser.

In the balance of the social effects of the system change there are phenomena to be found both on the positive and the negative side. With regard to occupational mobility, the favourable trends show perhaps a greater weight. Parallel with the changing system the enterprising spirit considerably increased, "in principle" even half the population would be ready to be an entrepreneur in some form. Therefore, if economic policy would stimulate starting new undertakings more than it does at present, this dynamism might further survive in the coming years.

However, it seems that beyond the mobility shown in the direction of enterprise, the system change initiated no significant vertical occupational mobility process, the proportion and number of the upward or downward mobile persons does not exceed the extent that can be found in our country or anywhere else in normal "peacetime". Behind this is presumably hidden the fact that in the past 25 or 30 years in Hungary,—in various waves—a significant "moving of cadres" occurred (after 1956, in the mid-1960s, the late seventies and, finally, from the mid-1980s on), and in the course of these the earlier "selection of the unfit", based on merely party interests, was gradually replaced by professional selection.

It should be taken as a warning, however, that, as a result of the circumstance, of the uncertainty of formerly safe workplaces, a nostalgia for state guaranteed full employment grew considerably. The extent of unemployment is still not unbearable, but the speed of its growth is disturbing. (The change of the system in Hungary is from this point of view, considerably more peaceful and balanced than it is in other former socialist countries—e.g. in the former GDR or Poland.)

Hence, with regard to the occupational structure, the changing system in Hungary has so far had mostly positive results. In the hierarchic motions the numbers of winners and losers counterbalance each other. The major winners are those—relatively many—who, linked to the change of system, dared to move towards the enterprising sphere.

In the area of income inequalities our experience is that, beside the steadiness of real incomes in the two years analysed, earnings and personal incomes became significantly differentiated. In this sphere the balance of winners and losers also shows an unfavourable picture, the share in the population of those whose income position worsened is greater than that of those whose improved.

Deterioration of the income situation is especially significant in the case of pensioners and of those who were recently pensioned. They cannot be considered losers of the change of the system as in Hungary the depreciation of pensions is a long known phenomenon. On the other hand, 5 percent of the population was able to double their income and the majority of these was able to make its material position considerably better as a result of the change of the system.

Interestingly, in the income of families no such differentiation appeared. The explanation for this is presumably that even recently a change in demographic structure more strongly influenced a family's economic situation than the earnings of the family members. However, the relative weight of earnings and incomes still increased. The differentiation of the personal incomes resulted not in the differentiation of family incomes, it rather rearranged the income position of the families. This change, in turn, can be considered favourable, for it is in conformity with the population's sense of justice if concrete living conditions of families are influenced by earnings rather then by demographic circumstances.

So far social political interventions have avoided the fall of poor behind the average social position. However, the number of those living below subsistence level increased at a significant rate. Since merely a small part of the population living below subsistence level—4 percent of the total population—is permanently in such a position, it is an especially important problem that in the rearrangement of the income situations the relative position of the population living above subsistence level but below the average deteriorated most powerfully.

All in all, in our survey the socio-economic effects of the change of the system can be unequivocally demonstrated. Thus, the view that the change of the political system was not at all followed by the change of the systems of society and economy is not fully acceptable. The changes may be deemed too slow, but they have certainly started. In our analysis we have pointed out undoubtedly negative tendencies, in its totality, however, we must say that the widespread despair which is exhibited by public opinion research in Hungary is not justified. The change of the system is in progress,—true, from many aspects, slowly, but without traumatic shocks and without mass sacrifices.

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THE USE OF COMPENSATION IN ECONOMIC ADJUSTMENT PROGRAMMES

B. GRESKOVITS

The author attempts to assess the relevance of compensation, a specific set of economic policies and political measures, by which governments try to ease political tensions arising from their stabilization and adjustment programmes. When collecting certain controversial issues and reacting to them, the author aims at developing a conceptual framework for the explanation of diverse characteristics and patterns of compensation to be found in concrete economic reform episodes. The discussion addresses two main issues: 1. who are (or are to be) compensated; and 2. how are they compensated if economic stabilization and adjustment is to sustain.

Nobody doubts that political factors can play a crucial role in the success or failure of economic adjustment programmes. However, most blueprints designed to stabilize and structurally adjust the economies of the LDCs in the 80's, and the Central and Eastern European countries in the early 90's, have mainly focused on economic issues.

Important details of programme design—such as the appropriate policy-mix, the sequencing of policies or the use of one or another instrument—lead the agenda of the policy-makers and their international advisors' discussions. However, relatively less attention is paid to the complex and careful *political engineering* required by comprehensive economic reforms.[1] If our aim is a better understanding of the interaction between politics and economic policy-making, and of the programmes themselves, our analysis certainly has to go beyond brief, wishful statements that mention the "necessary social acceptance and support" of the adjustment, or on the "governments' strength or credibility".

The political engineering of stabilization and adjustment usually focuses on solving the political difficulties around economic reforms. Such difficulties may arise from the distribution effects associated with the programmes. Stabilization policies, for example, often involve sharp drops in real wages, and an increasing number of bankruptcies as a consequence. Trade liberalization programmes also change the pattern of income distribution: they involve losses for import license holders and import-competing producers, yet benefit exporters and the rest of the economy. The distribution and sharing out of the burdens of stabilization and adjustment, and the initiation and implementation of programmes without creating social unrest—

[1] In fact, an impressive segment of political science and political economy literature has been emerging in the 80s, with valuable insights into the political environment of Third World reforms (see references of this paper). However, too little from those results seems to have had any influence on the blueprints on the Central and Eastern European transition so far.

these are the crucial issues reformist governments and political systems often have to face.

One specific set of measures by which governments address political tensions arising from stabilization and adjustment is compensation.

In this paper we attempt to assess the relevance of compensation from the point of view of economic adjustment. In collecting details about controversial issues and reacting to them, our critical survey has aimed to develop a conceptual framework for the explanation of the diverse characteristics and patterns of compensation to be found in concrete economic reform episodes.[2]

While various specific forms of compensation may be observed only in connection with concrete programmes, it has not been our intention here to explain how one or another compensation measure complements specific reform policies. This is the task of empirical studies aimed at the politico-economic analysis of various adjustment episodes in different countries.

Instead, the discussion below will address broader and more general issues: (1) what is compensation? (2) who receives (or will receive) compensation? and (3) how are they compensated while a politically engineered adjustment is carried out? While specifying our interpretation we shall compare compensation with a few other types and forms of government intervention, such as "mainstream" stabilization and adjustment policies, the political measures aimed at increasing the government's autonomy in initiating and implementing reforms, and economic populism. When answering the questions "who is to be compensated and how are they to be compensated?", the goals of compensation need to be made clear, then we can assess and compare the justification for compensating specific economic, political and social groups, affected by the reforms; this involves the poor, the working class, business, the "winners" and the "losers". We shall also address the role and the significance of various political and economic interest organizations from the point of view of compensation.

The paper will remain general when defining the stabilization and adjustment programmes themselves. By mentioning "economic reforms", "mainstream reform policies" or "stabilization and adjustment programmes", we are also referring to the stabilization efforts, trade reforms, and adjustment packages, initiated in the LDCs and lately in Central and Eastern Europe. These have received and some still receive strong support and assistance from the IMF, the World Bank and other international organizations.

We are aware of the fact that various reforms differ from each other in significant details and effects. However, from a more general point of view they show important similarities as well. The "standard stabilization package", as referred to by the authors of a recent blueprint for reforming Eastern Europe, has tended

[2]The author is grateful to Carol *Graham*, Mihály *Laki*, Kamilla *Lányi*, Peter *Murrell*, and Joan M. *Nelson* for their valuable comments on an earlier version of this paper.

to be a crystallization of stabilization efforts made in various LDCs, and typically consists of tight fiscal policies aimed at fiscal consolidation. Also tight monetary policies are intended to sharply decrease money growth, eliminate subsidies, and bring about price liberalization in order to decrease price distortions. Furthermore, in many cases the package has included anti-inflationary wage policies. (*Blanchard et al.* 1991)

Trade reforms typically involve the elimination of quantitative restrictions, substantial cuts in tariff-protection, the elimination of foreign trade state monopolies and, usually, various incentives for exports as well. In our paper we shall not discuss the relevance of standard policies for the problems of Southern or Eastern economies, nor shall we check their internal coherence and theoretical cohesion.

Instead, we shall attempt to analyze and classify compensation with regard to the questions above. The analysis will be based on the simple, general assumption that mainstream reforms may face political difficulties associated with their effects on income distribution, and that these difficulties may involve methods involving political engineering—among them compensatory measures.

What is compensation?

We have found it necessary to develop our own definition of compensation, for while both the necessity and the appropriate forms of compensation are widely discussed in the literature, there is still some uncertainty prevailing as to what compensation means precisely. There are also some contradictions between different interpretations with regard to its goals and targets.

"Compensation" in our interpretation is one of the ways of managing coalitions of interests for enhancing the viability of economic stabilization and adjustment programmes. It covers *a set of economic policies and political measures that are designed to achieve a specific political goal.*[3]

This goal is *to overcome political opposition to the reform* by reducing the motivation and chances for the formation of an anti-reform coalition and neutralising anti-reform threats in the short and medium-run.[4]

Compensatory policies and political measures may include:

[3] *Kaufman and Stallings* (1991) when defining Latin American populism, elaborated a logical pattern, that in part is applicable for our concept on compensation as well. However, we do not think that compensation and populism are identical. We shall specify their differences later in this paper. Another part of our definition is based on *Waterbury*'s notion on coalition management. (Waterbury 1989)

[4] For a detailed discussion of various actors' possible threats to the reforms, like strikes, riots, capital flight, remittance withholding, hoarding and unsecured borrowing see Waterbury (1989).

(1) *popular sector policies*, either in the form of distributing income-producing assets, (like land, emergency employment programmes, access to higher education) or current income transfers (like food aid, price subsidies); (*Nelson* 1989b)[5]

(2) policies facilitating *factor-mobility*, (like migration policies, retraining, housing policies and deregulation);[6]

(3) measures, focused at *creating trade-offs between different reform policies*, implemented both in the same reform phase and intertemporally through the sequencing of the reform process. (*Haggard and Webb* 1990; Waterbury 1989)

(4) measures granting *"grace periods"* in order for economic actors to adapt, in the form of a phased implementation of individual adjustment policies (like gradual price and trade liberalization steps);

(5) finally, measures that *distribute political benefits*, by providing improved access: either to political power (like organization- or participation-rights for the unions, executive or administrative jobs, influential distributional positions), or to political freedom (like measures aimed at democratization).

The policies and political measures listed above are not compensatory policies "per se". They may also be implemented in a context which is entirely different from compensation.

For example, non-reforming governments might also initiate popular sector policies, justified by their need for political support, or—as in the case of "pro-poor" policies—by general humanitarian or moral considerations. (Nelson 1989a) In turn, measures aiming at improvements in factor-mobility, or granting grace periods for adaptation, may be important elements of reforms, independently of any considerations about compensation.

However, such policies and measures definitely may and will be used in order to create trade-offs between losses and gains among those specific actors who are politically influential with regard to the prospects of adjustment. In our discussion they will be interpreted as compensation means if their capacity to create trade-offs is politically relevant for the policy-makers.

To further elaborate our definition some additional remarks will be formulated below.

Compensation and the mainstream reform policies

Of course, compensation is not the only, nor even the most significant policy designed to make economic adjustment feasible and sustainable. Indeed, it is usually of secondary significance, relative to the "mainstream" reform policies:

[5] A careful and enlightening analysis on different types of pro-poor policies in different countries has been done by Carol *Graham*. See for example Graham (1991; 1992a; 1992b).

[6] For examples see *Doner and Laothamathas* (1992); *Onis and Webb* (1992).

like price and trade liberalization, exchange rate, fiscal and monetary policies, and institutional reforms.

In the medium and long run, these mainstream policies are expected to become primary vehicles for mobilizing sufficient political support for the reforms by creating economic benefits, and bringing about pro-reform interest coalitions of the beneficiaries. While well-designed reforms can be sustainable without extensive compensation, the latter obviously will not be sufficient to maintain sustainable political support for the adjustment if the mainstream policies fail. However, compensation may prove to be important for the prospects of reforms in the short and medium run, especially if the supply response is belated.

Compensation differs from the macroeconomic policies that constitute the core of the reform. This is not only with regard to its secondary significance, but also with regard to the direction of its actions, and the economic and political actors targeted.

Compensation is designed to counterbalance the primary effects of the adjustment policies to a limited extent and for a limited period. However, its impact often appears to be more complex: while certain forms of compensation may partly countervail the effects of certain policies of the reform-package, they may enhance the effect of others at the same time.

While "mainstream" policies normally target the perceived winners of the adjustment, compensation targets those who feel they are losing.

Compensation: an alternative to oppression

Moreover, compensation does not entirely cover the whole set of economic policies and political measures used for overcoming opposition to reforms, and targeting those who feel they are losing.

In fact, reforming governments are frequently very active in implementing a third set of measures, aimed primarily or partly at the destruction of the economic and political power-base of the opponents of adjustment. (Certain privatization or nationalization policies, anti-corruption purges of the bureaucracy, legal or formal prohibiting of unions or political parties may be mentioned as appropriate examples.)

Compensation can be differentiated from this third set of policies on the basis that it implies the distribution of, as opposed to being deprived of, economic and political benefits.

Compensation and populism[7]

In finishing this section on definitions, we must point out the differences between policies aimed at compensation and populistic policies.

Although compensation often includes policies that target the "popular-sector", this is not identical with populism.

The distinction is important, partly due to the undoubtedly apparent threat to adjustment attempts. This threat may take the form of setbacks of a populistic character, that arise because of the excessive distribution of exaggerated compensatory benefits.[8] Fuelled by the critics' fears of exaggerations that are of a populistic breed, policies of a truly compensatory nature may, in due course, awake criticism for themselves being "populistic", and implying all the negative connotations of that notion.

What are the actual similarities and differences?

a) Like compensation, economic populism is also represented by a set of policies designed to maintain and increase the political viability of the government. Yet, unlike the former, it does not constitute merely a secondary feature, but the primary, mainstream policy-profile of the executive. As Kaufman and Stallings (1991 p. 16) stress in the context of Latin American populism "... we are referring to the political and economic characteristics of governments, not just to isolated policies, or to the movements or parties, associated with political leaders."

b) Compensation and populism often target the same actors: urban poor and semi-poor strata, the working class, and domestically oriented business. However, while these actors are, without doubt, the winners from populism, they are the typical losers from adjustment and stabilization programmes—i.e. the programmes compensation is associated with.

c) Also, while populism is directed towards actors and is constituted by the primary support groups of the government, those targetted by compensation, typically do not.

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[7] For a detailed discussion of the political economy of populism in the Latin American context see Kaufman and Stallings (1991).

[8] With regard to the transparent borders between compensation and populistic setbacks, Joan M. Nelson's argumentation is worthwile citing: "In contrast to the very poor, urban middle strata can pressure governments through strikes, protests, and in democracies, the ballot box. Political elites view their opposition as a serious threat to the sustainability of adjustment programs. This can become a self-fulfilling prophecy, since efforts to placate the urban popular sector are likely to undermine the coherence of economic stabilization and adjustment programs." (Nelson 1992)

Is there any need for compensation at all?

For any further analysis of compensation, it may be helpful to elaborate three more questions, with regard to its characteristics.

1. Is there any need for compensation at all?

2. Who are (or are to be) compensated?

3. In which way are they (or are they to be) compensated?

The professional literature has developed a few theoretical, political and humanitarian arguments to justify compensation.

In a recent paper, Haggard and Webb (1991) point to the justification provided by the *classical welfare theory*. If a reform with a typical mix of losers and winners is to be a Pareto optimum, losers must be compensated.

The *political argument* for compensation, which has been mentioned by several authors, points out the use of compensation to secure support for or at least acquiescence in, adjustment policies. (Haggard and Webb 1991; *Cornia, Jolly and Stewart* 1987)

There is too, a *humanitarian justification* for cushioning the effects of adjustment on the poorest of the society. (Haggard and Webb 1990)

However, there are several arguments against the idea of compensation as well.

1. With regard to the case of one group of perceived losers from adjustment—i.e. the poor—Haggard and Webb (1990) refer to opinions according to which the *adjustment process itself may be welfare-enhancing* for those groups. This is because they lacked the political power to benefit from the policy regime prior to the reform. Therefore, there is no need to "purchase" their loyalty through compensation.

While leaving unanswered the question whether reforms in any way provide the poor with access to those benefits lost by the gainers of previous regimes, this argument assumes at least political indifference on the side of the poor who "cannot lose, what they never had". This is just like consumers in a shortage economy, whose consumption is constrained by a lack of goods before, and then a lack of money after the price liberalization.

De facto continuity or even slight improvements in the economic situation of the poor however, do not necessarily translate into political neutrality and indifference with regard to the overall changes. In the context of the Zambian exchange-auction in the mid-eighties, *Bates and Collier* (1991) point out: the Zambian poor opposed the reform, and helped to stop it, for they—wrongly—assumed that their living standard dropped relative to the rich.

Moreover, even if the poor themselves have felt indifferent, this in itself has often been insufficient to keep them outside of emerging anti-reform coalitions of the losers. Nelson (1989a; 1992) points at the frequent alliances of the poor with more politically influential middle-income groups. The alliance not only empowers the poor with some support for their interests, but the opposite is even more true:

if middle-decile groups are politically activated against the reforms, it is easy for them to mobilize the "neutral" poor for anti-reform actions.

2. An argument with somewhat similar content may be backed by Pfeffermann's notion; he stresses that while distributional pro-poor policies may be justified on humanitarian or theoretical grounds, in the *absence of economic growth* they may help the poor to a small extent only. "Economic growth sustained over years is by far the surest way to raise the living standards of the poor. The record of punctual interventions such as rural development programs is mixed at best." (*Pfeffermann* 1991)

This argument focuses on the welfare-enhancing nature of growth-oriented economic adjustment which rewards even the poor in the medium and the long run.

It is easy to accept that economic growth is the best means to alleviate poverty, but there is also no doubt that sustained growth is a medium and long-term prospect at best, for most of the reforms. As *Geddes* (1991) argues, although according to economic theory most individuals will be better off due to their countries' structural adjustment in the long run (relative to a non-adjusted situation) most of the adjustment policies have few short-term beneficiaries.

Consequently, while there is less doubt about future gains, the question about immediate losses and their impact on the prospects of the sustainability of reforms remains open. Obviously, nobody can benefit in the long run from reforms that are halted half-way because of their unbearable short-term hardships.

3. There is a third argument which refers to the *requirements of the treasury*, and focuses on the fiscal infeasibility of compensation.[9]

Here again, nobody doubts that mainstream fiscal austerity may pose severe constraints on compensatory payments. However, we think that the poverty of the public household has to be interpreted in strictly relative terms. In other words: governments have to figure out the optimal trade-off between the payments that burden the budget, and the increase in the political feasibility of the reforms. With regard to the cost of compensation, reformist governments face the usual optimization-problem. This is not different from those associated with the opportunity-cost of any other policy-decisions.

4. According to a fourth argument some compensatory measures may *undermine the reform*. For example, if workers are cushioned from the effects of a nominal devaluation by wage increases, this directly undermines the objective of increasing competitiveness. (Haggard and Webb 1991) This may be true again, but only if we take it to the extremes. Earlier, we pointed to the possibility that adjustment initiatives may collapse as a consequence of excessive and careless use of compensation.

[9] This argument is referred to by Haggard and Webb (1991).

However, beyond extremes, if one or another type of compensation turns out to be the inevitable political cost of initiating or sustaining reforms, it is still legitimate to ask what makes more sense: to implement an economically "suboptimal" reform, or to initiate an "optimal", but politically infeasible one? The question put here asks about the very justification of approaches such as "muddling towards reform", as practised in Ecuador (and discussed by *Grindle and Thoumi* 1991) or the more effective "two-steps forward, one-step back"-tactics, followed by Özal's government in Turkey, (analyzed by Onis and Webb 1991)—especially when compared with adjustment programmes, based on the illusory "quick-fix scenario". (Nelson 1989c) We accept Waterbury's (1989 p. 55) argument: "Some resources will have to be used for essentially political purposes, and because resources are scarce, such utilization will appear wasteful from an economic efficiency point of view. It should not be forgotten however, that a regime that alienates most or all of its coalition partners will not be able to pursue the adjustment process."

5. Compensation, according to a fifth argument, is wasteful and unnecessary if it implies the government's *"jumping on the bandwagon"*. There is no need to compensate losers who dispose of, and are able and willing to, use their own resources—i.e. to overcome their losses on their own. We fully support this argument.

6. Joan Nelson (1992) has developed an argument that concerns the *likely recipients* of politically-motivated compensation. While the cited UNICEF study assumes that the poor are politically significant in resisting adjustment, this is not the typical case. Instead, the greatest political threat to stabilization and adjustment programmes is posed by popular-sector groups, including organized labour, and sometimes the private sector itself. Based on this fact, Haggard and Webb argue that it may be normatively difficult to justify compensation for these groups.

Clearly, both the theoretical and the humanitarian justification for compensation may be questioned by the fact that the dominant recipients of compensation intended for the poor, will often be their politically more potent allies.

However, even this assumption keeps the political argument for compensation unchallenged. Indeed, rather than decreasing it, in fact increases the overall political efficiency of compensation if it helps to overcome opposition among those whose threats to the reforms may be more dangerous than those of the poor. Clearly, this statement does not reflect any anti-poor sentiments on the part of the author; moreover, it does not reflect any moral consideration at all, because the considerations are *purely methodological*. It merely points at the consequences stemming from the political efficiency criterion for compensation.

Sad and cruel though it might seem, purchasing the loyalty of the politically influential urban semi-poor and working class of society may be more effective (although both morally and theoretically less justified) from the point of view of the political feasibility of stabilization and adjustment programmes, than to help the politically marginalized poor to adjust and survive.

Our overall view is that most of the arguments against compensation listed above are not persuasive enough. Specifically, while effectively they might question both the theoretical and the humanitarian justification for compensation, they fail to challenge the political argument that supports its necessity. However, from our point of view its political justification seems to be the key argument for compensation.

Also, in accordance with our definition, the efficiency of compensation has to be measured in political terms: namely, the extent of its impact on overcoming the opposition to, and increasing the political feasibility of the reforms.

The costs of compensation should be evaluated on the same basis, and measured by the opportunity costs of not using economic and political resources for compensation.

Who are (or are to be) compensated?

Waterbury argues, that "...a range of discretionary practices in resource allocation—especially those that are designed to compensate partially those interests that suffer the most in the adjustment process—should be accepted." (Waterbury 1989, p. 55)

Nelson clearly points at the poor, who, as losers from economic adjustment, are appropriate candidates for compensation. However, she stresses: "But with the exception of short-term externally financed relief, most pro-poor measures entail shifting resources from better off groups, including lower-middle and near-poor classes. Such measures inevitably generate strong political resistance. Moreover, these same middle-class and near-poor groups, particularly in the cities, often had been hard hit by depression and adjustment. They are not the most vulnerable, but they may be the most aggrieved victims of the decade's lost growth. Compensatory programs often do help these groups. In contrast, the tightly targeted pro-poor measures also advocated by international agencies and Northern governments are not likely to soothe growing adjustment fatigue and political resistance." (Nelson 1989d, p. 17)

Haggard and Webb are less specific in hypothesizing that successful reform programmes involve compensation for "groups, negatively affected by the reform" in order to reduce political resistance. (Haggard and Webb 1990, p. 20)

In a later paper Haggard and Webb explicitly, but generally refer to "losers". (Haggard and Webb 1991, p. 21)

So, who—after all—are (or are to be) compensated: those *"who suffer the most"*, those who are *"the most vulnerable"*, or *"the most aggrieved victims"*, or just *"losers"* in general?

The authors quoted agree in general, that *losers* from the reform are (or are to be) compensated. (None of them refers to any of the *beneficiaries* from the reforms as possible candidates for compensation.) However, there is some obvious uncertainty with regard to specification of the losers' groups concerned.

Compensation to those "who suffer the most" (or: lose the most), reflects—perhaps—theoretical (Pareto-optimum-) considerations; "the most vulnerable" clearly reflects humanitarian concerns; compensating "the most aggrieved victims" reflects political efficiency-considerations, while compensating the losers by and large reflects the view that "losers" can be clearly separated from "winners".

These different criteria specify different groups to be compensated: those, who are the most vulnerable, the—mostly rural—poor, are not identical with those, who lose the most: namely, the—mostly urban—lower-middle classes, wage-earners, and semi-poor; in turn, the latter groups are sometimes joined by other losers, such as semi-rich or even rich—mostly urban—private-sector groups. In the political arena, it is these groups which act as the most aggrieved victims. (Nelson 1992)

Also, the differences above point to the *divergence* between the criteria for theoretically, morally and politically efficient compensation. Compensation that helps the poor may be mostly efficient with regard to humanitarian considerations, but it is not necessarily efficient in political terms. In turn, effective compensation in political terms does not necessarily help those who have lost the most.

In accordance with our definition, and stressing the political function of compensation, we will use political efficiency as the major criterion for identifying the actors who are (or are to be) compensated by reformers seeking to overcome political opposition to the adjustment.

The general concern: "compensation, as an idea refers to losers" will be specified and reconsidered in two ways.

1. Not all of the losers are (or are to be) compensated.
2. It is not exclusively losers who are (or are to be) compensated.

Which losers need not to be compensated?

The first statement is in accordance with opinions found elsewhere in the literature: nobody advocates a "total" compensation of all losers.[10]

[10] As Waterbury stresses: "... compensation cannot be equivalent to the full size of the loss." (Waterbury 1989, p. 41) Haggard and Webb too, point at the threats from the excessive use of compensation. (Haggard and Webb 1990, p. 21)

However, if reforming governments use political—and not, for example, theoretical or humanitarian—efficiency, as a criterion for selecting candidates for compensation (as they in fact often do), the structure, and volume of compensatory benefits determined by political distributional patterns will not be a precise negative reflection of the pattern of the economic distributional impact of the adjustment.

Also, the structure of the group which benefits from compensation will probably significantly differ from that which comprises the losers in the reform process.

This takes us to some broad generalizations.

No matter how large their losses, or how vulnerable they are, there is no political justification, and therefore no need to compensate the following actors:

a) Losers who dispose of, and are able and willing to use their own economic resources to overcome their losses without external help. (Compensation provided in such cases would fail to shape political attitudes to the reform. Instead, it would assist processes that would happen anyway, at less public cost.)

b) Losers who do not dispose of, or are not able or willing to use their political resources to overcome their losses by adversely shaping the very pattern and/or the political prospects of the reform.

c) Losers, whose ability and/or willingness to use their political resources to overcome their losses by adversely shaping the very pattern and/or the political prospects of the reform, can be influenced in a more effective (or less costly) way by measures other than compensation: for example, persuasion, obfuscation and containment, as listed by Nelson (1989c).

d) There may be no need to directly compensate losers who only indirectly—through their allies or through intermediary organizations—are able to shape the very pattern and/or the political prospects of the reform in an adverse way.

While specifications a to c limit the scope for compensation to the politically potent losers, specification d enlarges the reformist government's field of action even within the narrowly defined group of the potent opponents. We shall discuss the implication of this fact later.

However, the group of the potent opponents to the reform, or the emerging anti-reform coalition is not necessarily made up exclusively of losers. In fact, at times it may be joined by perceived winners. Should they too, be prevented from anti-reform actions by compensation?

The "winners"—"losers" identification problem

The idea of limiting compensation exclusively to losers may reflect a perceived need for theoretical or humanitarian justification.

However, as we said earlier, such justification may be unnecessary—compensation may be considered to be legitimate on purely political grounds alone.

Also, as we stressed earlier, a primary preliminary condition for limiting compensation to losers is that losers from the reform can be clearly separated from the winners.

However, we shall argue that while meeting this condition may be easier theoretically, in reality it may address a more complex problem.

Evidence on stabilization and adjustment episodes points at the sometimes astonishingly severe difficulties reformist governments meet while identifying, politically targeting, and separating groups, affected by their programmes in different ways.

These difficulties sometimes remind us of the problems governments face while initiating industrial policies with arbitrary targeting. In fact, picking the winners from policy reforms in advance, or at least winners in the short and sometimes even medium run, may prove to be as complex a task for the reformers as for technocrats responsible for industrial targeting—given that the winners the latter target are intended to be leaders of future economic development.

The reasons why difficulties arise in separating the winners from the losers may be associated on the one hand with the government's disinterest in, or ignorance of, or incapability of political targeting and, on the other hand, with the winners inability or unwillingness to identify themselves as winners, and act accordingly in the political arena.

Reasons for the difficulties with political targeting

Reformers' disinterest or ignorance

According to the evidence provided by studies of individual countries, some reformist governments simply did not feel it was important to know how and which economic or social groups were affected by their reforms, or who was losing or benefiting from them.

An example of the reformers' disinterest in identifying winners and losers is provided by *Herbst and Olukoshi* (1992) in the context of the Nigerian economic reform.

Dictatorships based on rigid, ideological prejudices, yet giving an extraordinary degree of autonomy to decision-makers, often ignore the distributional effects of their economic policies.

Reformers' inability to realise political targeting

There are some cases where the policy-makers' insufficient capacities to properly evaluate the effects of their own policies limit the chances for a correct separation of the winners from the losers.

As demonstrated by Bates and Collier (1991), there is convincing evidence concerning the Zambian government's failure to identify the real winners and losers both from the point of view of its exchange-rate policies and its "corrective" social policies. Because of the lack of technocratic expertise, the Zambian government just mistook the winners for the losers, and mistargeted both its mainstream and compensation policies.

In other cases, as shown by *Leight and Loftchie* (1991) in the context of Ghana's trade policies, a confusing legacy of chaotic trade protection—accompanied by distributional effects that are not clear for the policy-makers themselves—may heavily constrain a government's ability to separate winners from losers. With such a legacy, a trade reform may produce unexpected responses and patterns of support and opposition.

However, as stated above, the limitations on the reformist government's capacity to separate winners from losers may be magnified by a couple of reasons associated with the winners' inability or unwillingness to identify themselves as winners and act accordingly.

Diverse, simultaneous positions of the actors in the economic structure, uncertainty and imperfect information

Haggard and Webb (1991) stress that economic actors occupy several different positions in the economic structure. They are, simultaneously, producers, consumers and recipients of transfers. This may make it difficult for them, and for the government to calculate the costs and benefits of reform or the trade-offs between short-term losses and longer-term gains. One more factor constraining correct calculation is uncertainty and the imperfect information that typically surrounds reforms. As a consequence, as Anne Krueger and Dani Rodrik have pointed out, winners from reforms may oppose policies that favour them because of the uncertainty of their effects.[11]

[11] Referred to by *Haggard and Cooper* (1991) Herbst and Olukoshi (1991) explicitly point at the impact of imperfect information on the anti-reform attitude of the winners in the Nigerian reform's context.

Complexity and diversity of the policy-package

Provided that the reform package is comprehensive enough—consisting for example of fiscal, monetary, trade reform, and structural measures—the firms, individuals and households may be affected simultaneously by diverse and contradictory policy effects in their respective positions in the economic structure. Calculating costs and benefits may be more difficult in this case, depending on how complex the policy-package is.

Divergent economic and political distributional effects of the reforms

Individuals, firms and households also simultaneously hold diverse positions in the political structure as voters, members of trade unions or business associations, or political parties; thus they have different abilities to influence policy-outcomes. Just like positions in the economic structure, those in the political structure are also in motion during a comprehensive economic reform. Changes in the actors' political positions, associated with reforms, may also confuse their perceptions of whether they are winners or losers.

This may add to the identification difficulties. Therefore, given the possible divergence of the political and economic distributional effects, the actors' overall evaluation of their actual situation requires calculating tradeoffs between economy and polity as well.

One case which exemplifies this problem is provided by analyses which demonstrate the elementary reluctance of the financial sector—sometimes one of the winners from reforms in LDCs—to identify themselves as winners. This is a consequence of their justified fears that the government would exploit their identification by exposing them as political scapegoats for the hardships of the majority of the population.[12]

Competition for relief-measures

Nelson (1989b, p. 97) explains how competition among different groups of losers from economic adjustment may constrain the governments' ability to effectively target the most needy groups as recipients for relief-measures. "In many

[12] Examples for this problem are mentioned by *Stallings* (1991); *Maxwall* (1991); Herbst and Olukoshi (1991) in the Chilean, Brazilian and Nigerian context, respectively. In Nigeria, merchant bankers, who profited from financial deregulation, have not been actively supporting the adjustment policies, because the government several times attempted to deflect political blame for the increasing "undervaluation" of the Nigerian currency onto "irresponsible" bankers.

countries, however, elite opposition to pro-poor measures may be less crucial in shaping policies and resources than the competing claims on state resources of middle and working class groups—who are better off than the poor, but by no means rich, and far more organized, vocal, and active in politics."

However, competition for state resources will not be limited to losers only: in fact nothing will restrain certain groups of perceived winners from competing for public resources with each other, and with the losers. Indeed, the winners' chances in this competition may be substantial if they dispose of sufficient political power, and they can acquire public relief from the hardships of adjustment.

It would be easy to expose these "double-winners" simply and generally as rent-seekers and, consequently, to question their eligibility for relief-measures. However, there are two additional obstacles to the clear separation of winners from losers and to a certain extent these justify some of their claims on compensation.

Time-lag between the appearance of the losses and the gains from the reforms

Nelson points at the impact of time lags between the gains and the losses from the reforms, in the context of the stabilization programmes of the early and mid-eighties' "quick-fix" scenario. "The key political problem, according to this scenario, was that benefits lagged behind costs. Costs were obvious and immediate, while benefits were delayed; many of those who stood to gain doubted that the benefits would materialize, or that they would in fact reach them." (Nelson 1989c, p. 5)

Nelson's view on time lags is shared by other authors.[13]

The argument concerning losses preceding benefits, exposes the difficulties associated with the economic actors' uncertainties in assessing tradeoffs between their long-term gains and short-term losses. Also—together with the other above-mentioned obstacles to a correct assessment—it underlines the chance that real winners might misinterpret their actual, dynamic positions in the course of reforms.

Clearly, if potential winners are severely hurt by some of the policies of the reform-package in some of their simultaneously held roles in the economic structure, prior to being rewarded by other policy-effects in another of the positions that they occupy, they will easily mistakenly identify themselves as losers, and remain passive, or join the opposition to the reform in the political arena.

Moreover, the hardships which the long-term winners experience from being short-term losers and the possible consequence of their negative attitude towards the reforms, may be enhanced by their *lack of resources, or the time* needed to move out from the losers' position.

[13] See for example Geddes 1991; Leight and Loftchie 1991 with statements on the pains of economic change that become apparent well before the benefits begin to materialize.

Lack of means, or time for factor-mobility

Exploiting the potential benefits from structural adjustment often requires decisive action from the potential winners. Benefits often reward only time-consuming and painful adjustments involving restructuring and reorganization on the part of the firms and households. Moving out from the losers' position requires ambitions, time and resources for factor-mobility.

A move towards export-orientation and away from import substituting strategies may well exemplify this process. Even if the reforms provide clear incentives for such a course, the missing or badly functioning institutional mechanisms might constrain or delay the mobility of the production factors—the labour, the land or the capital. As a result, the adaptation-process may be delayed or fail, for potential winners will not support the adjustment policies or will even oppose the reforms.[14]

Similarly, during tough stabilization episodes involving wage cuts and drops in living standards, it is very relevant for the political prospects of the reforms whether the short-term losers—the workers—remain cemented in their losers' positions "forever", or are granted by time and resources the opportunity to move out of their situation as compensation for their short-term losses.

In the analyses on economic reform episodes, an abundant set of positive and negative examples point at both the significance of this issue in the context

[14] Like manufacturers in Nigeria, for example, who—according to Herbst and Olukoshi (1992)—while being perceived beneficiaries from trade reforms, were actually active participants in the coalition opposing the reform programme. This could happen because many of the manufacturers represented by the MAN (the main Nigerian business organization) severely doubted whether they could dispose of the resources sufficient to reorganize their production and trade activities, so as to be able to benefit from trade reforms. Similarly paradoxical was the position of Senegalian industrialists, who felt seriously threatened by the consequences of the country's trade liberalization attempts. Although the government designed a set of "accompanying measures" to help firms to adjust to the fierce foreign competition (like measures lowering excessive labour and energy costs, as well as financial assistance to firms seeking to restructure, a new investment code, and increased export subsidies), only a few of those measures were in fact implemented. Senegalian industrialists, who, after restructuring stood to win from the reforms, never supported them, because they remained deprived of the means and institutional settlements to move out from the losers' position. (*Samba Ka and de Walle* 1992) A similar situation may have contributed to the fact that Polish farmers and their political and interest-organizations early became the toughest and best organized opponents of the Balcerowicz-reforms. Although in the short run they were losers due to the consequences of increased input-prices and intensified foreign competition, in the medium and long run they could have been the major winners from the Polish trade reforms, as main exporters in an agro-exporter country. However, the reform failed to compensate them, either in the form of the necessary "grace period" to restructure, or with the provision of the institutional environment needed to the farmers to move out from the losers' position. Moreover, even the incentives to export eroded quickly, as inflation persisted. All this helps to explain, why perceived winners attempted to halt the Polish reforms. (*Johnson and Kowalska* 1992)

of strategic coalition management, and the active use of compensatory policies for turning short-term losers into medium- and long-term winners.[15]

As stressed above, there are many constraints to both the identification of the beneficiaries with the winners position, and the attempts of a reformist government to bring about successful political targeting.

Reasons like: lack of information; uncertainty about the consequences of the reform; the complexity of economic and political impacts, influencing the actors' perceptions on their current and future situation; political fears; the losses preceding gains; the lack of time, means and institutional settings. These things may often cause prospective winners, aggrieved by their immediate losses, to be involved in active or passive political resistance to the economic adjustment.

To avoid the emergence of anti-reform coalitions, supported even by the perceived winners in the reform process, it may have political justification—and sensitive reformers in fact often keep this in mind—to extend the range of strategic compensation *beyond specified groups of losers.*

Indeed, compensation of specific groups of beneficiaries from the reforms for their short-term losses may sometimes even be more efficient politically—and therefore more legitimate—than the compensation of specific groups of losers. However, both the humanitarian and the theoretical justification are clearly lacking in the former case.

Who are (or are to be) compensated: "losers" or "opponents"?

Therefore, our answer to the question, "who are (or are to be) compensated", is not: "losers" in general, nor: putting it more specifically "certain groups of losers".

Politically *influential opponents* of the reforms—no matter if they are winners or losers—are to be (and are often in fact) compensated instead, if the political goal of compensation—namely, the neutralization of the opposition to the adjustment—is to be met.

Based on that notion, the group of the "opponents" to be compensated may be specified as follows:

a) Losers who dispose of, and are both able and willing to use, their political resources to overcome their losses by adversely shaping the very pattern of the reform and/or the political prospects of the reform.

b) Losers whose ability and/or willingness to use their political resources to overcome their losses by adversely shaping the very pattern of the reform and/or

[15] Positive examples of the governments' assistance to short-term losers' moving out from their losers' positions are described by Haggard and Cooper (1991) about Korea, by Onis and Webb (1992) about Turkey and by Doner and Laothamathas (1992) about Thailand.

the political prospects of the reform, cannot be influenced in a more effective (or less costly) way by measures other than compensation: namely, they cannot be influenced by persuasion, obfuscation or containment.

c) Allies of losers, who only jointly or indirectly—with or through their allies—are able to adversely shape the very pattern of the reform and/or the political prospects of the reform.

d) Short-term losers but medium- and long-term winners, who lack the time or the means, or the institutional mechanism needed for moving out from the losers' position, but dispose of the political power for adversely shaping the very pattern of the reform and/or the political prospects of the reform. This is especially so if they feel they are fixed in the loser's situation. (The typical forms of compensation for such opponents are—or are to be—, "grace periods" and policies that improve factor-mobility.)

Undoubtedly, the pattern of compensation based on any concrete combination of the actors listed above may and will perhaps much more directly reflect (and, probably even encourage) political pressures, than theoretical economists, technocratic policymakers or international organizations would like to see.

However, we—along with many reformist governments—argue that from the point of view of the adjustment chances it is better to let compensation at least partly filter and absorb those pressures, than to respond to them by delaying, adversely reshaping, or undoing the adjustment policies.[16] Compensation, according to this interpretation, may to some extent cushion the mainstream reform policies themselves from disruptive political pressures.

However, one additional important specification will be helpful in analysing and understanding the actual patterns of compensation as implemented in different reform-episodes.

Earlier, we specified who is not (or need not be) compensated. At the same time, we pointed at the possibility of partially avoiding direct transfers to those (or to some of those) whose opposition to the reform is to be overcome through compensation. This takes us to the argumentation below.

Actors represented and their representations

Earlier in this paper we defined the political justification for compensation in terms of a specific political goal: to overcome opponents to the reform.

[16] We fully share Waterbury's view: "In sum, it may make political sense for the leadership to use more resources on coalition maintenance early than to risk isolation or retaliation later." (Waterbury 1989, p. 41)

Meeting this goal presumes a corresponding political behaviour of the actors compensated: at least passivity or sometimes even support with regard to the adjustment-measures.

Compensation is politically efficient—and therefore justified—if it prevents reform measures from being delayed, undermined or stopped as a consequence of riots, strikes, demonstrations, hoarding, capital flight or other threats coming from opponents.

The crucial question with regard to the efficiency is: who, or which types or groups of actors compensated, are able to guarantee the predominance of at least the passivity or even some of the support in the political arena? Clearly, politically efficient compensation has to target exactly those actors who have the decisive say in what will happen, and who dispose of the actual power which can influence the process and direction of policy-making.

It is both helpful and relevant from the point of view of our argumentation, to refer to two basic types or groups of political and economic actors. In principle, they dispose of the power that influences the feasibility and sustainability of the economic reforms. Actors disposing of such powers can either be *individual actors*, like consumers, producers, households, firms, voters, activists or sympathizers of a political party, the rank and file of a labour union, the members and sponsors of a business-organization or a lobby; or they can be the *political or economic interest-representatives* of the same individuals, like political parties, trade unions, lobbies, consumer or business interest-organizations.

Individuals certainly have some, even if limited, means to *directly* influence the perspectives of economic adjustment by the multitude of their individual actions.

However, their efficient means are *indirect* ones: most of the political impact of individual actors on policy-making, succeeds through their economic and political interest-representatives. Fragmented individual interests—that both support and oppose the reform—must be aggregated and organized for joint political action in order to be effective enough.

An individual firm may escape from the burdens of a new taxation by tax-evasion, but cannot change the tax law. However, a business organization sometimes can.

Similarly, in order for a strike to be organized, it needs not only workers who are willing to strike, but also a labour union, that finances the strikers, formulates their goals and negotiates their demands.

The significant impact of the organization form and level of political and economic interests on both the pro-reform and anti-reform coalition management is widely accepted and discussed in the political economy literature. Fragmentation of the losers' or of the winners' groups, and actions in one or another reform-episode is one of the standard arguments used to explain the lack of an efficient opposition to, or—conversely—of, the efficient political support for the adjustment.[17]

However, much less attention has been paid to the implications of the interest-organizations' political importance for the targeting of compensation.

Let us continue the argumentation based on the simple example above: if, for example, the political goal of compensation is to prevent strikes against the consequences of one or another reform-measure, in principle two ways may be followed. Compensation may focus at directly preventing the workers from striking, or preventing their unions from organizing a strike. In other words, the executive may intervene either directly, at the level of the individual actors, or at the level of their representatives, (or at both levels).

To choose one of the ways that involves specific forms of compensation as well, will require a comparison of the economic and political costs and benefits that are associated with any of them.

Compensating the interest-representation body instead of the individuals of its rank and file, may sometimes turn out to be the less costly, or more politically efficient way.

Clearly, one might argue that compensation of the boards of labour unions and political party elites cannot substitute for compensation of their rank and file, or their constituencies—at most, it can only substitute for a fairly limited time. This might be so, because the boards and elites, controlled by the individual actors, may be punished by the latter for not representing their economic and political interests efficiently enough.

However, by stressing the "retrospective" nature of the voters' control, Geddes concludes that control or punishment may considerably *lag behind* the injuries that are caused to the voters' economic or political interests.

While explaining the constituencies' limited capabilities to control their political organizations in a more up-to-date and efficient way, Geddes (1991) points at the role of the insufficient information they can gather (and at the cost of acquiring more), both on their organizations' positions and their own interests.

Needless to say, the deficiencies and costs of that information may constrain the impact of the represented actors' judgements on the activity of their representative. This is not only with regard to political parties, but also to labour unions, business organizations, religious orders, dominant allies, and representative individuals as well.

Moreover, a few additional factors can be mentioned as possible reasons for the relative autonomy of the representative from the represented: the lack of alternative choices for representation (as in one- or two-party systems, or regimes

[17] For example Haggard and Webb (1991), in the context of the obstacles to the emergence of pro-reform coalitions, refer to the common observation that beneficiaries tend to be diffuse and weakly organized relative to those favoured by policies prior to the reforms.

restricting the competition of labour or business organizations); or the time lags inherent in the election system; or the one-sided dependency of those represented on their representative. This dependency is based on inequalities of an economic, political, cultural or religious nature.[18]

The relative independence of the representative bodies from the represented actors in principle allows for union boards, political party elites or other types of interest organizations to take compensatory benefits for the injuries caused to the interests of their rank and file, constituencies or members. In this they do not have to fear immediate retaliation. In principle this allows a government to *compensate representatives instead of those they represent*. That is, the government can entirely or partially avoid immediate direct transfers to those (or to some of those) whose opposition to the reform is to be overcome through compensation. This option may have an impact both on the volume and the type of compensatory benefits that are indispensible for meeting the political goal of compensation.

The relevance of the principal—agent problem

The statement above leads us to examine the analytical relevance of the *principal-agent problem*, which is necessary for understanding the political economy of compensation.

This well-known concept has been used in order to explain the tensions of the interactions between the owners and the management within firms. However, we believe that its analogic explanatory merits may prevail in different areas as well.

The concept is based on two underlying conditions: (1) the management's interests may considerably differ from those of the owners; and (2) it disposes of a relative autonomy, in enforcing its interests to some extent, even at the expense of the owners.

As we saw, the latter condition prevails with regard to the interaction between individual economic and political actors, and their interest organizations. Whatever the constraints, in order to limit the representatives' strict dependency, economic and political interest-organizations may act to some extent and, within certain time-limits, considerably freely from the actors represented by them. Also, their freedom allows them to "cheat" their members and constituencies, "earning for their own pocket", in the same way as managers realize their interests, sometimes at the cost of the owners.

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[18] Nelson in the context of the pro-poor policies argues: "... many organizations in which the poor and near-poor participate are dominated by slightly better off members, whose priorities are not necessarily the same as those of their poorer associates." (Nelson 1989b, p. 99)

Yet what about the former condition? Might not the interests of political or economic organizations considerably diverge from those of the individual actors they represent, or even be in contradiction with those?

Given the delayed and imperfect control of corrective mechanisms, which we referred to above, while the prevailing contradictory divergence is less likely in the long run, it is much more possible in the short and medium term.

The probability for the existing divergence between the interests of the representatives and the represented is partly explained by the fact that while individual actors of the economy and the society will be directly and primarily sensitive to the economic distributional effects of the reforms, their political and economic organizations' direct and immediate interests are much more bound to the *political distributional effects* of economic adjustment.[19]

In other words, while constituencies (and the rank and file) formulate their interests with regard to economic reforms mainly (although not exclusively) in economic terms, political party elites (and the boards of economic interest organizations) do not: their related interests are mainly (but not exclusively) of political (or of a near-political) nature. The latter directly focus on the way economic adjustment will influence their chances and the means needed to acquire or to maintain political power (or influence). Their interests are directly bound to: improvements in, and expansion of their organizational abilities, in terms of their relationships with other boards or elites, or the government; improvements in the volume of organization properties; improvements in their ability to provide constituency services; their ability to distribute benefits among their activists and individual voters.[20]

Given an "optimal" set of political institutions, from the point of view of adjustment the economic and political distributional effects and therefore the interests of the boards and elites, would not diverge from those they represent. According to Geddes an optimal set of institutions would maximize the political power of the beneficiaries in line with the particular reform policies, and minimize the political power of the losers. (Geddes 1991) In this case, pro-reform coalitions would almost "automatically" be made up of the political representatives of the winners,

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[19] In fact, while there is a common sense that economic adjustment programmes have widespread economic distributional effects, much less attention in the political economy has been paid to the essential implications of the political distributional effects of comprehensive reforms. However, just as adjustment involves a reallocation of economic benefits and losses, at the same time it may facilitate a redistribution of political power and influence as well. Actors in the political sphere, like political parties, trade unions, governments or their specific agencies, or diverse organizations of civil society, may lose in power and influence, while others may turn out to be winners in political terms.

[20] Geddes (1991) argues, that for politicians who want to be elected and to remain in office (and their influence over policy heavily depends on their ability to win and retain office) their electoral concerns take priority over policy concerns. As a consequence they try to attract voters by advocating policies favoured by them, distributing benefits to their activists and to individual voters, and providing them with individual constituency services.

while passive or active reform-resistance would be directly linked to those who lose because of the economic adjustment.

However, the given set of political institutions often turns out to be "suboptimal" in the sense that they distribute political benefits and losses not in a parallel, but in an *asymmetric* way as compared with the economic ones.

This often allows for competition between political and economic interest organizations in their quest for *political benefits, even at the cost of economic losses* for the actors they represent.

This may explain the paradoxical phenomenon involving representatives of those hurt by reforms occasionally participating in pro-reform coalitions. Political parties or trade unions that join (or at least do not oppose) stabilization pacts, despite the severe wage-restraints involved, are the most obvious examples.[21]

Compensating principals, agents, and agents of agents

Given both the divergence of the interests of the representatives and those they represent, and the relative autonomy of the former in enforcing their specific interests, the analogic use of the principal-agent problem turns out to have some analytic merits and explanatory powers for the political economy of compensation.

The analogic problems that are extensively discussed above, allow us to define the constituency of a political party, the rank and file of a trade-union, and the members and sponsors of a business interest-group as "principals".

In turn, the representatives of those individuals—that is the political organizations, the trade-unions, and the employers' organizations—can be interpreted as acting as "agents" in their interactions with the principals.

It appears to make sense to identify even a third—relatively autonomous—tier in the interaction between different types of actors.

From time to time, interest-groups attempt to influence policy-making not merely by using methods of their own interest-representation (like organizing wage-negotiations, strikes) but through political channels as well. Instead of direct political action on their own, they may attempt to gain influence through their "agents", their political associates and their allies. Then, political parties often seek alliances with labour unions, business organizations, and other representatives of individual actors of the society. In both contexts, political parties, or other strictly political organizations that are strongly and closely associated with trade unions, business

[21] Examples are Spain's Moncloa Pact in 1977 and Mexico's Economic Solidarity Pact in 1987. Neither of them was opposed by either opposition political parties (in the Spanish case) or by labour unions (in both cases), although the stabilization caused severe hardship to labour. On the Mexican Pact see: *Kaufman and Bazdresch (1992).*

organizations or other interest-groups of the civil society may function, and therefore be interpreted as "agents of the agents".

Due to the imperfections inherent in political systems, as reflected by the principal-agent problem, governments not only may compensate agents instead of principals, but they may also overcome opposition to their policies by distributing political benefits to the former as compensation for the economic losses of the latter.

Provided that this form of compensation is efficient politically, it may involve less costs in economic terms than the direct compensation of principals by distributing economic benefits.

However, it may turn out to be much more costly in political terms for the governments and thus it may require a significant redistribution of political power in exchange for establishing a political environment that makes reforms feasible.

Governments have to precisely evaluate the tradeoffs among the economic and political costs and gains and losses associated with their specific compensation techniques. However, the very existence of forms of compensation by distributing political benefits magnifies the governments' field of action for compensatory practices, and improves their chances of establishing political environment that favours reforms.

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STABILIZATION AND GROWTH IN HUNGARY—SOME THEORETICAL CONSIDERATIONS

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Hungarian economic policy has to realize two goals: to stabilize the economy and to emerge from the recession. In the case of Hungary the two problems cannot be treated separately. In this study first the instruments applied in the course of stabilization are analyzed and their short- and long-term impacts presented. Then the possible condition of emerging from the recession are discussed. For this the causes of the possible lasting duration of recession have to be clarified. Beside the necessary instruments of economic policy it seems indispensable to bring about some presently missing institutions.

Although Hungary cannot be considered a developing country, by the state of development of the institutions of market economy it undoubtedly stands nearest to them. The study deems it fundamentally important to develop institutions to make stabilization lasting and to provide the foundations for growth.

Introduction[1]

At the present time Hungarian economic policy is dominated by two direct goals: *stabilization of the economy and getting out of the recession*. The debates concerning these subjects have become particularly lively, especially this year. The aim of this study is to support the statement that *in the case of Hungary the two issues cannot be treated separately from each other*. In the first part of this study the economic policy tools used during the stabilization will be analysed and their short- and long-range effects will be assessed. In the next part the potential conditions needed for sustainable growth will be dealt with. In connection with this the causes of the persistence of the recession will also be analysed. In addition to the necessary economic policy instruments, the creation of some still missing institutions seems to be indispensable. It will become clear from the analysis why questions concerning stabilization and growth cannot be separated.

The arguments presented here rely strongly on the literature on stabilization and on the experience of developing countries that have implemented stabilization programmes. Although Hungary cannot be considered a developing country, with regard to the level of development of its market economic institutions, it is undoubtedly close to them. Setting out from this premise, the study looks at im-

[1] For their comments on the first version of this study the author wishes to express his thanks to I. *Ábel*, P. *Kaderják*, F. *Karvalits*, J. *Kornai*, K. *Lányi*, G. *Oblath*, Z. *Spéder*, Gy. *Surányi*, and L. *Urbán*. However, the author is responsible for any mistake that may occur in the paper.

portant trends in modern theories on investment, and for the sake of low inflation and sustainable growth it deems it very important in some spheres to carry out a *rapid institutional development.*[2]

The study does not aim to give comprehensive answers to questions concerning the transition from planned to market economy.[3] Also, there is no analysis of the conditions of privatization and the growth of the private sector. However, the need to improve the investment climate is mentioned because this is an indispensable condition for both the growth of the private sector and privatization itself.

The instruments of Hungarian stabilization

In this study I use the notion of stabilization in a double sense. On the one hand, stabilization encompasses successful handling of inflation and, on the other hand, it refers to the prevention of inflationary pressure. Stabilization programmes are of two basic types: orthodox and heterodox.[4] Orthodox stabilization involves a combination of fixed exchange rates and a strict budgetary and monetary policy; heterodox programmes complement these with price and wage control. The Hungarian attempt at stabilization is largely an orthodox solution where, in the slowing down of inflation, real exchange rate appreciation policy has played an essential role.

In the following, the effects of reserve requirements (the most important tool for controlling the money supply process), of exchange rate policy and of the budget deficit will be analysed. The aim of this section is to demonstrate that the economic political instruments that have so far been applied during the stabilization can only be used in the short run. If they are used for a longer period the recession will deepen and thus stabilization itself will be undermined.

The regulation of money supply

Monetary management in Hungary originally used two methods for controlling money supply. One of them was regulation by refinancing credit limits, and the other involved regulation by the reserve rate. The most important market eco-

[2] About experiences related to the ineffectiveness of the instruments of stabilization and the dangers of liberalization in the developing countries, see *Diaz-Alejandro* (1985).

[3] Comprehensive works on this question are: Kornai (1990), *Lipton and Sachs* (1990), *Blanchard et al.* (1990), *Csaba* (1991).

[4] A review of the question is given by *Halpern* (1990), *Dornbusch, Sturzenegger and Wolf* (1990) pp. 46–60., and *Kiguel and Leviatan* (1992).

nomic tool for money supply control—namely, open market operations—cannot be regarded as workable, despite the attempts that have been made. Up until now Hungarian practice has been similar to that of those developing countries where the market of government securities is very small.[5] In the period that has just passed the sterilization of the increase in money supply, brought about by increasing foreign exchange reserves, was achieved through a rise in either the reserve ratio or the reserve base. Along with the elimination of refinancing credit limits the importance of the reserve ratio will also continue.

However, regulation by the reserve ratio significantly distorts the operation of the financial intermediary system.[6] For understanding this, let us consider the following. Let r_d be the real interest rate on deposits and r_l the real interest rate on loans, i_r the nominal interest paid by the central bank on reserves, π the inflation rate, k the reserve ratio, and D the amounts of deposits held at commercial banks. In this case $L = (1-k)D$. Let us suppose, furthermore, that the bank earns zero profit,[7] and does not face any risks.

Therefore

$$i_r kD + (r_l + \pi)L = (r_d + \pi)D.$$

In this case the following relation exists between deposits and loan interest rates:

$$(r_l + \pi) = (r_d + \pi)/(1-k) - i_r k/(1-k)$$

Rearranging this, we obtain the following equation on the difference between the real rates of deposits and loans:

$$r_l - r_d = r_d k/(1-k) - i_r k/(1-k) + \pi k/(1-k)^8$$

Supposing that the nominal interest paid on reserves is inelastic and adjusts to the inflation very slowly; in this case the gap between the deposit and loan interest rate increases when inflation and reserve ratio increase. In the case of a high reserve ratio, even a small increase in inflation may drastically increase the interest rate—primarily the interest rate on loans. If monetary policy tries to control

[5] *Király* (1991), *Claasen* (1992, pp. 151–153).

[6] *McKinnon* (1991) pp. 43–54. *Siegel* (1982). Since raising the reserve rate has the same effect as raising the reserve base, to make it simple, in the following only regulation by the reserve ratio will be analysed.

[7] This means an implicit assumption regarding perfect competition. However, if we were to examine the reserve ratio regulation beside the presence of market imperfections, it would not modify the major conclusions, but would complicate the analysis.

[8] The gap between real interests is the same as that between the nominal interests rates. If we add the inflation rate to the left side of the equation and also subtract it, this is immediately derived.

money supply by raising the reserve ratio, the financial intermediary system will, after a while, get into a situation where *even a small increase in inflation*—say, as the result of an external shock—may lead to a considerable narrowing of granting credits and *to serious disturbances for the financial intermediary institutions*. Beside a high reserve ratio, as in Hungary, it is questionable whether interest rates can be achieved which encourage savings but do not discourage investment or do not deepen the recession.

Controlling the money supply by raising the reserve ratio causes a further problem. The reserve requirements influence the interest on deposits and loans. So, if the central bank pays no market interest rate on reserves, the commercial banks suffer a relative loss and this must be paid by somebody. The commercial banks can attain this by paying a lower interest rate on deposits and by charging higher ones on loans. Hence, the possibility of raising the reserve ratio depends basically on the interest elasticity of deposit and the loan demand. If deposit demand is interest elastic, the decrease in deposit rate caused by the increase in the reserve ratio leads to a decrease of deposits, i.e. to an increase in the velocity of money. On the other hand, if the interest rates are too high, and the banks cannot lend, they reduce their interest rate on deposits and loans. The latter also leads, through the decrease of the deposits, to velocity of money—that is, unless securities are sold to them from the central bank. *In this way, ceteris paribus, increasing the reserve ratio indirectly causes inflation*,[9] albeit with some delay.

Thus, the domestic methods of money supply control are contradictory. They are not suitable for handling inflation, and in the long run sometimes doubts emerge even with respect to their short-term effectiveness. If the results which have so far been achieved by monetary policy go unchallenged, it still seems questionable whether it will be possible to control money supply in the future with the present tools in order to achieve antiinflationary targets.

Exchange rate policy

The exchange rate policy in Hungary, characterized by fixed exchange rates, has been a very important part of anti-inflationary monetary policy. The central bank decelerated the inflationary pressure by a devaluation which, compared to the inflation, was relatively low. Because of this, in 1990 a small, and in 1991 a considerable real exchange rate appreciations were implemented. These, according

[9] This is exemplified by Chile's monetary history in the second half of the 1970s. McKinnon (1991) pp. 55–64. With regard to the problem a comprehensive statistical analysis is given by *Brock* (1989).

to all indications, will continue even in the current year. However, such a policy can only be followed in the short run.[10]

In order to understand this, let us consider the following. The goods and services in the economy can be divided into two groups: the group of tradeable and the group of non-tradeable goods. The former may be export- or import-substituting goods. The effect of real appreciation on income streams starts in favour of the producers of the non-tradeable goods, though recession may either strengthen or weaken this effect. Somewhat more difficult is the answer to the question of whether, within the group of the tradeable goods and as the result of real appreciation, a redistribution of incomes will follow from the exporters to the importers. This depends, namely, on the extent to which the export sectors need imports on the input side. If this necessity exists only to a small degree, the effect of real appreciation on the redistribution of income starts in favour of the importers; if the case is contrary to this, redistribution will not start or will only take place to a very slight degree. However, owing to the contradictory effects, a *worsening of the balance of payments will not necessarily come about in the short run.*

In Hungary, the real appreciation exchange rate policy was implemented alongside very special conditions. The collapse of CMEA trade, on the one hand, deteriorated the current account. On the other hand, recession generated by the demand shock reduced imports. This had a favourable influence on the current account. Third, it also had a favourable impact on the current account in that, owing to the very deep recession, companies in the short term simply had no possibility other than continuing exports. According to standard microeconomic logic, this is worth maintaining even at a loss, until the returns cover at least the *variable costs*. In this case the company is able to maintain the sales until it can somehow also cover the *fixed costs*. In the Hungarian case this is mostly realized by disinvestment—commonly called "living up the property". This is, however, limited by the size of the assets which can be used for this purpose, or by the demand for them.

It is also important to examine what kind of *long run effects* a strong real appreciation policy may produce. As a result of real appreciation, investments in the sectors producing tradeable goods decrease, and those in the sectors producing non-tradeable goods increase.[11] In the long run, this causes a deterioration in the current account. The sharpening import competition causes a decline in the average return, and also contributes to the deepening of the recession. To form a judgement on how these factors have been influencing the Hungarian economy is difficult because the real appreciation policy coincided with the last step of import

[10] On the effect of real revaluating exchange rate policy see Oblath (1992).

[11] When the economy is in recession, these processes are even more complex, since total investments also decline. It might easily be that, within it, the import substituting investments fall at the most rapid rate.

liberalization. This in itself enhanced import competition. This is the reason why it is so difficult to distinguish between the results of trade liberalization and those of the real exchange rate appreciation. Yet even in this case it is valid,—due to even cheaper imports—that the range of products to whose production it is worth allocating resources, is continually narrowing. In this sense, a real exchange rate appreciation will slow down the restructuring of the Hungarian economy in transition and thus also hold back its emergence from the recession.

Appreciation may gain support if the central bank continues this policy at a time when considerable capital is flowing into the country. At such times, in countries with a foreign exchange market, an appreciation is brought about. Massive capital inflow, as an external shock occurs in a country if the profit expectations of foreign investors significantly improve. This comes about usually as the consequence of (trade and/or financial) liberalization of the economy. This can happen when a country seemingly becomes overnight the home of prospective chances. However, the high profit expectations of foreigners remain independent of the actual performance of the economy only in the short run. In other words, owing to the recession elicited by the real appreciation foreign capital which has, up to then, flown in, will leave the country. This leads to exchange rate collapse and to accelerating inflation, as can be demonstrated by the examples of several developing countries.[12]

In the case of a real appreciation exchange rate policy, relative cheapening of foreign currencies leads to flight from the domestic currency, unless the interest rates are high enough to make the holding of domestic currency preferable. In the past year this has certainly been true for Hungary. The same method can be used for encouraging foreign investments in the country.

Beyond the fact that high interest rates might increase the recession, it is much more important that, owing to interest differences, foreign indebtedness becomes cheap for domestic agents in the economy. In the case of even a slight liberalization of the capital movements, the process may rapidly and easily lead to an excessive external indebtedness of the domestic enterprises—especially if raising credits by the budget keeps the inland interest rates above the level of exchange rate risk and foreign interest rates.[13]

It follows from what has been said, that a strong real appreciation of exchange rate as a tool of stabilization, can only be used in the short run if a deterioration of the current account is to be avoided.[14] The various experiences of the developing

[12] *Edwards and Montiel* (1989) pp. 877–884. *Savastano* (1992) pp. 96–98. The existence or non-existence of a foreign exchange market in itself does not help to find the solution to this problem. Whether or not revaluation (or appreciation) comes to pass, depends not on the market exchange rates but on monetary policy.

[13] McKinnon (1991) pp. 113–119, *Reisen* (1990) pp. 83–86.

[14] Dornbusch, Sturzenegger and Wolf (1990) pp. 57–58, *Aghevly, Khan and Montiel* (1991) pp. 13–19.

countries indicate that weak economic performance and current account disturbances can only be avoided by countries that change their real exchange rates slowly.[15] The conclusion is that even if the central bank wishes to implement a harder selection in exports and import substitution, *the real exchange rates can only be raised slowly*. In this case, however, from the aspect of slowing down the inflation, the control of money supply should have a greater role than at present.

The budget deficit

Literature on the Hungarian budget in general comes to the conclusion that today a more significant reduction of the deficit is practically impossible. In recession revenues unavoidably decrease[16] and the expenditures increase. In addition, in transition—i.e. owing to privatization and liberalization—revenues necessarily decline, even if the government takes every possible measure to collect the outstanding debts. Moreover, the Keynesian argument can be heard that in recession, decrease in government expenditure would deepen the recession even more.[17] Namely, the most important question is generally not raised: this question is concerned with whether fiscal policy is consistent, with antiinflationary and current account targets.[18]

For this purpose let us review the connection between budget deficit and stabilization with some simple equations, describing the linkage between budget deficit and inflation. Let X be the nominal *primary deficit*, H the stock of high powered money, and B the volume of the indexed government bonds. The total budget deficit is financed by issuing base money ($\mathrm{d}H/\mathrm{d}t$) and by issuing bonds ($\mathrm{d}B/\mathrm{d}t$). On bonds it pays a nominal interest of $r+\pi$ where π is the inflation rate. Consequently, the following relationship exists:

$$X + (r+\pi)B = \mathrm{d}H/\mathrm{d}t + \mathrm{d}B/\mathrm{d}t.$$

[15] *Cooper* (1991) pp. 76–78, McKinnon (1991) p. 29.

[16] This interrelation is also supported by empirical experience. See *Roubuni and Sachs* (1989) pp. 110–119.

[17] It must be noted that even without a more detailed analysis, with regard to small and open economies, this Keynesian argument has a very great weakness. Namely, government consumption gives rise to a significant demand for non-tradeable goods. This, in turn, strengthens the effect of the real revaluating exchange rate policy, and reduces investments in the sectors producing tradeable goods. Therefore, keeping back recession in this way may cause serious problems in the balance of payments.

[18] On consistent fiscal policy, see: *Anand and Wijnbergen* (1989) pp. 27–35, *Blanchard, Chouraqui, Ragemenn and Sartor* (1990) pp. 10–16, *Dornbusch* (1992) pp. 25–27, *Wijnbergen* (1990) pp. 308–315, Dornbusch (1989) pp. 197–198.

If this equation is divided by the nominal GDP (pY), where p is the price level, and Y the real GDP, then we get the proportion of the deficit to the GDP. Let us mark the ratio of the earlier variables to the GDP with lower-case letters; furthermore $H_g = (\mathrm{d}H/\mathrm{d}t)/Y$ and $Y_g = (\mathrm{d}Y/\mathrm{d}t)/Y$. Using this notation we get the equation:

$$\mathrm{d}b/\mathrm{d}t = x - H_g b + b(r - Y_g).$$

This relation is one of the most important equations in the macroeconomics of government finance.[19] For the time being, $H_g b = 0$, i.e. the government does not finance the deficit by money creation. It can be seen that if the real interest rate on government debt exceeds real growth rate, then debt/GDP ratio grows without limit. In the following, let $H_g b = 0$, furthermore $x = 0$, and r and Y_g remain constant. In this case, by solving the differential equation $\mathrm{d}b/\mathrm{d}t = b(r - Y_g)$, we obtain the result that after t years the government debt/GDP ratio will be

$$b_t = b_0 \exp[(r - Y_g)t],$$

provided that the primary deficit over the whole time was 0. If we assume that the difference between the real interest rate and real growth was throughout five years, an average of 7 percent, and interest payments amounted to 5 percent of the GDP,[20] then this ratio will increase in five years to more than 5 percent; in ten years it will be approximately 10 percent. Also, if in the meantime the primary deficit was not zero, the accumulation of debt would be more rapid.

The results is obvious. After a certain time, people will not buy bonds. In this case, without money creation, the deficit cannot be financed. Thus, governments increasingly resort to money creation, and here no central bank, however independent, can be of help. It is not necessary to grant credit directly to the budget, for it is enough to create additional liquidity for commercial banks to buy government bounds. With further reference to money creation, a change in the method of financing in recession is especially dangerous.[21] On the other hand, the total budget deficit will become more and more rigid, investments will be crowded out, and the reduction of the deficit will only be possible by reducing the debts. In such a case the government is strongly interested in inflation, and this may help in the reduction of the real debt burdens.[22]

In market economies, participants in the market react to a high deficit by increasing inflationary expectations even when the increase in money supply has not

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[19] *Haliassos and Tobin* (1990) pp. 901–904, *Buiter* (1985) pp. 28–36.

[20] In Hungary up until last year the real income and the interest rate on state bonds were more than 7 percent and the interest burdens in 1990 amounted to 3 percent of the GDP.

[21] *Bruno and Fischer* (1990) pp. 264–272, *Melnick and Sokoler* (1984) pp. 234–235.

[22] *Keynes* (1923) pp. 53–60.

started. In such cases the expected future inflation causes inflation in the present. This could occur even in Hungary. If economic agents do not believe the Ministry of Finance when it indicates that the present budget deficit can be financed without money creation, we may count this as a sign of growing inflationary expectations.

What follows from the foregoing is that in the case of an economy which is in recession, further accumulation of debt causes problems even in the short run, especially if in the meantime the domestic interest rates increase. Experiences up to now also indicate that only those countries with high growth rates have been able to maintain a significant deficit without inflation. However, where a recession was going on, the budget deficit led to a three-digit inflation within a few years.[23]

The necessary conditions for sustainable growth

In the following I am going to deal with the possible actions that could be carried out in the short run. These, based on the logic of the analysis, are indispensable for growth. In addition it is necessary to use those means and/or steps with the aid of which the government is enabled to *influence* the economic processes in a favourable direction. We shall see that the same instruments can also be used for a successful stabilization.

Investments and the recession

Stopping the decline of the GDP, or increasing its level, can take place in principle in the short run, if capacity utilization is low in the economy (which allows for an increase in output), or if new capacities are created by investments. In the long run, however, investments are important from the aspect of economic growth with the Hungarian economy in transition capacity utilization is low. However, most of the capacities created in the past cannot produce competitive goods. The ratio of GDP to investments continues to decrease for some time. *For this reason, growth in Hungary even in the short run basically depends on investments which can ensure sustainable growth and appropriate market shares for domestic enterprises both on domestic and foreign markets.*

Investments and uncertainty. Investments are basically "irreversible". Using investments for purposes other than their original ones is either impossible, or only possible with significant cost. Therefore, if the investor, owing to the adverse conditions, is later on compelled to stop production, he will not be able to recover

[23] *Easterley and Fischer* (1990) pp. 136–138. In the course of successful stabilization the budget deficit was always reduced but not always eliminated. *Dornbusch and Fischer* (1986) pp. 40–43.

all the investment costs, or, in extreme cases, he will lose them. However, the investor always has the possibility to wait for more favourable conditions, or for additional information with regard to the future. If the expectations for the future are very uncertain, the optimal strategy for the investor is to wait and do nothing, or to undertake short run investments.[24] The irreversible characteristic of investments has a few implications for economic policy. Creating a favourable climate for investments depends not only on the level of interest or tax rate but also on their relative stability. The absolute level of exchange rate is not important for the agents—rather, it is the fluctuation of that rate.[25] Below a certain level, a stable inflation rate may be more important than one that is on a low level but strongly fluctuating and, due to permanently unsuccessful attempts in economic policy, has the effect of increasing uncertainty.[26]

In Hungary the companies' inclination to invest, or the willingness of banks to lend, is basically determined by a *general uncertainty*. This is characteristic of all former centrally planned economies in transition. Therefore *the time horizon of investors is significantly shortened*. This is directly manifested in the fact that the banks practically grant no credits for a period of more than one year and accept no fixed deposits for more than one year. *The key strategy for acheving a sustainable growth path is to increase the time horizon of investors*, in order that they undertake long-term investments. If economic policy is not able to attain this, the economy will remain in recession in the long run. The short time horizon of investors is basically the result of the great uncertainty which is dominant in the economy. This uncertainty is generated by the following three factors: (1) rapid transformation of the economy's institutions and economic environment; (2) the lack of a few basic institutions and (3) the hesitant economic policy.

To realize the first factor rapidly is practically impossible. Therefore in the following I will not deal with this problem. In order to eliminate the second factor,

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[24] With regard to the consequences of the irreversible character of investments see e.g. *Bernanke* (1983). On their interrelations with other investment theories: *Serven and Solimano* (1992). A summary of the subject is given by *Pindyck* (1991). For more about the former planned economies, the problem is mentioned by Blanchard, Dornbusch, Krugman, Layard and Lawrence (1991) pp. 78–81.

[25] This, of course, does not mean that on the micro-level the level of the exchange rate would not be important for one or another company. On the macro-level, however, the effect of the real exchange rate on profitability, owing to the significant role played by the import costs, is ambiguous. This is the reason why, statistically, no significant relationship can be found between investments and the real exchange rate, except that the standard deviation of the real exchange rate relates negatively to investments. Servan and Solimano (1992) pp. 102–103. The current Hungarian exchange rate policy causes great changes in the real exchange rate.

[26] This solution is especially relevant in the developing countries, where the possibilities of collecting the taxes are rather limited. Therefore, a stable rate of inflation that is under control, is an effective method of financing state expenditures. Cooper (1991) pp. 56–57. This possibility may be important in the case of Hungary, too.

it is necessary to establish a few institutions which are still non-existent today. An evolutionary development of such institutions would be possible, but economic policy is badly in need of them at precisely this moment. The third factor is closely connected with the second one. The hesitation apparent in economic policy stems from the fact that the arsenal of instruments by which it can intervene in the processes of the economy is very poor, and thus it is unable to solve problems without causing considerable further troubles.

The banking system and business investments. One of the popular explanations for the low level of investments is that the *interest rates* are too high; thus it is not worthwhile for the companies to invest. On the contrary, based on theoretical considerations and on the practical experience of many developing countries we may say that *a significantly positive real interest rate is one of the basic requirements of growth*. Such real interest rates promote high saving rates, financial accumulation, and the growth of funds available for loans. According to conventional views the volume of investments is high when there are low interest rates. However, experience in several countries shows that high interest rates can accompany high investments and, consequently, high growth. The basic reason for this is that at low interest rates, investments are high but their efficiency is low. Namely, if interest rates are high, only investments of high efficiency can be implemented. Growth depends on the efficiency of the investments and not on their volume, although the effect of volume in the short run may be significant.[27] The high interest rates, of course, *must not be "too high"*. (Yet it should be admitted that there is no criterion for deciding what is too high.) However, in the Hungarian economy there is only a weak possibility of developing an interest rate which would be ideal from the aspects of both financial accumulation and investments. The present instruments for controlling money supply are not suitable and do not favour an operation with such a high reserve ratio.

Thus, the stock of gross domestic credit has to be influenced primarily not by an interest-reducing campaign but by a lowering of the risks the banks are working with at present. These are mostly caused by the fact that banks are imperfectly informed about borrowers. They may not increase their expected profit by an increase in interest rates. At higher interest rates borrowers expecting lower returns on relatively riskless projects will not apply for loans. Only applicants with higher return and higher risk want to borrow. Therefore, with increasing risks, the expected bank will decrease because borrowers may undertake riskier investments than those they announced to the bank (moral hazard).[28] On the other hand, high interest rates imply that. Under these conditions if the bank raises interest rates applicants with lower return and lower risk will drop out and the banks'

[27] McKinnon (1991) pp. 11–30.

[28] With regard to the apportionment of credits see *Stiglitz and Weiss* (1981), *Stiglitz and Dwight* (1990), *Vincze* (1991).

willingness to lend will decrease due to the higher risk of default. The banking system in Hungary is characterized by three additional sources of uncertainty: the overall uncertainty experienced in the economy; the special uncertainty which banks face; and the fact that the banks are owned by the state. The general uncertainty and instability can also be formulated in such a way that covariance between the returns on potential investments is positive, and this makes it more difficult for the banks to select among the applicants for loans.[29] The huge number of new borrowers about whom the bank has no information, increases the risk faced by the bank. Under such changes in lending conditions, a riskaners bank decreases interest rates in order to have more applicants, and more applicants with lower risk of default. It is a different situation if the bank is not afraid of risk. A typical reason for this may be either a strong deposit insurance system, or that the bank is in state ownership. At such times the risk-taking bank reacts to the increasing risk by raising interest rates, in order to increase its profit.[30] Several developing countries show examples of such bank behaviour. Whether or not the Hungarian commercial banks are averse to risk is difficult to assess. Their behaviour cannot really be described purely by this pair of notions. However, it is a fact that in addition to the inherited bad loans, they have already accumulated a significant number of bad loans. This indicates that they do not have a very careful lending policy.

The conclusion of the present subsection is that financial accumulation requires *a significantly positive real interest rate*, the level which can easily be observed by the public. At the same time, this will also have a beneficial impact on the selection of investments. The present instruments of monetary policy, however, make this difficult. The banking system is unable to cope with the high risks experienced in the economy,[31] and thus it restricts its lending activities. It seems that the rational decision for the system is not to grant credits to new borrowers.

Public investments. Based on international experience, it is obvious that in an environment of either a market economy or a non-market economy, public investments are relatively inefficient. However, there are certain investments which the private sector would not carry out even in a rapidly growing market economy. Owing to the shortened time horizon, the sphere of such investments in the former centrally planned economies in transition is very large. These are mainly infrastruc-

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[29] According to the theory of credit rationing, the investments can be ordered into groups so that the yields of the investments belonging to the individual groups can be characterized by an identical probability distribution. Probability distributions of the particular groups are independent of one another. This provides the theoretical possibility of selection. If, however, the probability distributions are not independent, even a theoretical possibility of selection is small.

[30] McKinnon (1991) pp. 84–92.

[31] *Sándor and Spéder* (1991). It can be recognized theoretically, and is also supported by practical experience, that during a recession it is extremely difficult to use monetary instruments to force commercial banks to extend their credit activities. *Stiglitz* (1992) pp. 285–297.

tural investment projects which usually enhance the productivity of the economy, even if their effectiveness is lower than if they had been implemented by the private sector.

However, it is necessary to call attention to two problems concerning the public investments. *On the one hand*, if the investment is financed by issuing bonds, this increases the debt/GDP ratio (unless it generates a very high growth). In other words, let us assume that the government undertakes an investment with net returns of 15 percent. If for this purpose it issues bonds with an interest rate of 7 percent, and meanwhile the profit tax rate is 40 percent, there still remains a two-percent gap between the revenue and the interest expenditure. However, increasing debt/GDP ratio implies inflationary dangers. *On the other hand*, the investment may determine future government expenditure. It is difficult for the government to react to unexpected budget disturbances by reducing expenditures which may increase indebtedness. Hence, the government has to choose a few well definable projects, the costs of which can be calculated, and their social efficiency has to be easily recognizable. As a result, *these investments become discrete* in the sense that it will be clear to the economic agents that this is a single action and the extent of such a government activity cannot be regarded as permanent. This will bring about the advantage that economic agents will immediately strengthen their activities, in the belief that this is an opportunity never to be recaptured.

Given the above, we can say that the debt management problems imply that *these investments have to be financed by money creation*. In this case, monetary policy has to control inflation with appropriate monetary policy.

The institutional conditions for sustainable growth

Uncertainty reduces the time horizon for investors. The cause of uncertainty in the economy is the lack of information. In economies in transition there is a lack of those institutions which might continuously provide costless information about important economic indicators. In addition, investments are also directly influenced by issues concerning the conditions under which the financial intermediary system would be able to handle the risks existing in the economy, and/or how it would be possible to eliminate the factors which have so far distorted the operations of these institutions.

The potential institutions for providing information. In the market economies there are basically two institutions which provide the investors, and the economic policy-makers with information about expectations concerning the future of the economy. These are the market for government bonds and the foreign exchange market.

The market for government bonds grants everybody reliable information on the term structure of interest rates and the long-term development of inflation. The information regarding the expected volatility of interest rates, owing to the irreversibility of investments, influences the decisions of investors at least as intensively as the level of the interest rates does. The problem is to find out how a concentrated market of long-term government bonds can be established when the time horizon of investors is so short that only a few will be ready to hold such assets. The long-term government bond is the only one which can reallocate incomes between two points of time. Therefore these are purchased first of all by institutions which themselves also pursue such activities—namely, the institutional investors. Such are the pension funds, insurance companies and mutual funds. Though development of these has commenced, conscious government development is still highly necessary in this sphere. It would be possible to establish a few state-owned pension funds, the assets of which would consist basically of government bonds. The pension funds could obtain the government bonds in three different ways. On the one hand, by making pension insurance contracts, they would provide current savings for the budget. Secondly, the budget would grant government bonds to the new pension funds from a certain share of the privatization revenues.[32] Third, some part of today's internal debts would be swapped for bonds which would be received by these pension funds. Though in this way the present interest burdens on the budget would increase, by linking them with the reform of the pension system, the future demand of the latter for subsidies would be reduced. While these institutions are in state ownership, the possibilities for investment—other than into government bonds—ought to be limited. For the credibility of this action, it would be necessary to set a time for the privatization of these institutions. In the case of risk-free assets, it would not be difficult. One of the basic conditions for doing this is obviously to invent such bond constructions which guarantee a proper real yield on the assets. The appearance of such institutions does not necessarily suggest that trading with the government bonds would begin, but it would be possible to bring about the institutions capable of continuously creating demand and/or supply for the state bonds. This may also promote the appearance of other investors.

Creating a market for the long-term government bonds would contribute to easier debt management. At present the budget is only able to issue short-term bonds and treasury bills. For this reason, the reallocation of current burdens over a longer time and the combination of this with a tax policy is practically impossible.[33]

[32] Without going into detail, it can be said that repayment of internal government debt—accounted between the central bank and the government—in a macroeconomic sense cannot be interpreted, and this is not even necessary. On this, see Oblath (1991). From this, however, it does not follow that the budget ought to spend the revenue from privatization on current expenditures. Since the budget deficit is significant and the danger of its spreading out is also a threat, privatization revenue can be of such a construction—the conversion of current revenues into bonds—which assures that capital, transformed at present into income, will become, in the future, again capital.

[33] On this, see *Bohn* (1991) and *Blanchard and Fischer* (1989) pp. 583–591.

This narrows the possibility of debt management, and also causes permanent liquidity problems. If the new institutions were to receive government bonds which, with regard to their maturity structure, would be properly formed, in the short run this in itself could improve the position of the budget. The above-mentioned institutions could also play a basic role in *controlling the money supply*. In this case the central bank would be able to carry out open market operations. It could then give up regulating the reserve ratio which leads to the distortion of the financial intermediary institutions.

The other basic institution suitable for reducing uncertainty is *the foreign exchange market*. With regard to the development of the foreign exchange market, its role in building of exchange rates needs to be pointed out. In addition to this, the foreign exchange market is also the most important institution for assessing short-run inflationary expectations. This is especially important at times when inflation is going on, because with the lack of such institutions the inflationary expectations depend on past inflation rates. Inflation thus becomes a self-strengthening process which is difficult to stop.[34] The foreign exchange market is the institution for building forward-looking expectations. However, in order to achieve a situation in which the exchange rates on the foreign exchange market appear to be credible, a minimum level of liberalization has to be attained.

The financial intermediary system. The institutions described above provide the banks and other financial intermediaries with basic information. Furthermore, they make it possible for *the commercial banks to avoid direct participation in deficit financing*. Ever greater government bonds would pass to the commercial banks because they would be the only potential investors. This does not simply crowd out investment but also reduces the effectiveness of the financial intermediary system. The commercial banks which play a basic role in budget financing are subject to increasing political pressure. This urges them to purchase securities, and this may narrow down the sources of loans.

The system of financial intermediary institutions has some problems that are independent of the ones described so far.[35] In its present from it is unable to deal with the high uncertainty that can be observed in the economy. The time horizon of the banks is as short as that of any other economic agent. Under such conditions the transformation of savings into investments is not efficient. The institutions for the division of risks, which reduce the risks of both the short-term and the long-term assets (guarantee funds, credit cooperatives etc.), are missing. For establishing these, no one else but the state has any resources available. Besides, there are not even any *information systems* available for helping in the selection of borrowers.

[34] Dornbusch, Sturzenegger and Wolf (1990) pp. 18–19.

[35] Sándor and Spéder (1992).

The economic-political conditions needed for getting out of the recession

In addition to the institutional changes that have to be carried out as soon as possible, economic policy also has to take definite steps in two spheres: in the management of the revenues and expenditures of the budget, and in the creation of a favourable atmosphere for investments.

Budgetary discipline. In principle, *fiscal discipline* is independent of the size of the deficit. The concept really means that the government adjusts the deficit and the ways of financing to macroeconomic circumstances.[36] It will select the proper forms of financing. For example, if the conditions allow, it will increase monetary expansion. If, however, in the given position, the extent of the deficit becomes dangerous, it will decrease the expenditures.

On the revenue side no fiscal discipline can be observed. The Hungarian tax system cannot be considered to be stable. The practice of a tax policy according to which the taxation rules for the next year came to be known in December of the current year, and the fact that they are formed in conformity with the momentary needs of the budget, largely contributes to the shortening of the time horizon of investors. Under such circumstances it is very difficult to make any kind of decision on long-term investments. In a developed market economy, where the institutional environment and the economy itself are stable, the government has more possibility to change the tax system frequently for the sake of its objectives. In a largely uncertain environment, however, where it is hard to find a stable point, the tax system might be a suitable point of orientation for the economic agents when making their decisions on investments.

Apart from a certain indexing which is now needed in accordance with inflation (e.g. connected with personal income tax) economic policy ought to *leave the laws on taxes and the tax rates unchanged for a longer time*. This would entail the danger that the effect of various disturbances would cause the budget deficit to grow. The solution for problems that emerge because of this course of action can be facilitated by the development of the earlier described, more elastic forms of financing, the reduction of the deficit, and/or the proper limitation of government investment programmes. The basic success of a tax policy of this type is conditional on whether the participants in the economy believe that the new tax policy announced by the government can be maintained. *Anyhow, the programme is more credible* if at the same time a reduction of the deficit also comes to pass. It is rather important that economic agents should believe in such a programme, because only in this case can favourable changes be expected in the investments.

Stimulation of business investments and the taxation system. The measures listed so far, by increasing the time horizon of the investors, and decreasing uncertainty in the economy will, in themselves, favourably influence investment activities.

[36] Cooper (1991) pp. 78–81.

It is necessary to promote investment by using tax policy instruments. In Hungary, compared to other countries, *the cost of capital is very high*.[37] Due to company taxation and to the amortization system, in order to achieve a given profitability for private capital, a higher pre-tax profit has to be attained in Hungary than in most other countries of Europe. This effect is also strengthened by double taxation of the dividends on shares. In the market economies, the retained earnings of the enterprises comprise one of the most important sources of investments.[38] However, in Hungary this is made difficult by the tax system. This also contributes to the fact that domestic enterprises are very sensitive to the changes in the interest rates on loans.

For this reason, stimulating investments is possible by investment tax credit. Firms will be able to finance their future investments. For a similar purpose the amortization system could also be turned in a favourable direction. For the sake of accelerating investments it could be announced in advance that the measure is a temporary one, and that after a certain time, the extent of the favour would be reduced.[39] The government could build further preferences into the system. For example, it could promote technical development by prescribing the duration that fixed assets would enjoy such a favour. The things mentioned above may be enough to create a favourable atmosphere for the investment.

Such a package of measures is suitable for introduction in the framework of a *comprehensive tax reform*. In the case of a change in the tax structure (taxes on consumption instead of taxes on income),[40] it would be possible to maintain the earlier level of revenues. The falling out of some revenues can be directly counterbalanced if the government stops some certain tax subsidies that have been enjoyed by some preferred company groups. For example, favours granted to joint ventures should cease, and should be set to the level of the newly introduced general favour. Namely, from the view of tax policy, preferences granted to particular groups represent a rather double-edged tool. Since passage among the groups is free, more and more companies try to enter the preferred groups using various tricks. Consequently, the basis enabling assessment declines, and in turn the budget deficit increases.

It would be difficult to make prophecies about the effect such a measure would have on investments in Hungary. According to experience in the market economies, if such a *tax cut comes to pass after a tax rise*, its investment-stimulating effect is much greater than if just a simple tax reduction had come to pass.[41] Thus,

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[37] *Andresson* (1991).

[38] Statistical data regarding this: Stiglitz (1992) pp. 277–279.

[39] Recommended, among many others, by *Bornsztein and Montiel* (1992) pp. 166–167.

[40] This is very frequent proposition with regard to the former planned economies. McKinnon (1992) pp. 104–105, Kornai (1989) pp. 69–70.

[41] *Summers* (1980) pp. 138–143.

as a result of a tax rise, investments diminish. This reduces the stock of capital, which may make the new investments more profitable. Therefore, influenced by tax reduction, investments will suddenly strongly increase. A slow increase of the tax burdens has been in progress in Hungary for a long time; hence, there is the change that in the case of the changes in the tax policy described above, investments will increase.

Conclusions

According to the ideas outlined above, the parallel aims of economic policy are: to keep control of inflation and to get out of the recession. I think there is no alternative to these. It is impossible to carry out first one of them and afterwards the other one. *Between the two there is no chronological relation, no trade-off. The instruments for promoting sustainable growth are the same for stabilization.* The means for Hungarian stabilization which have so far proved to be important—such as a real appreciation, or regulation of the reserve rate—are, in the long run not effective. Moreover, by applying them, the economy and the financial system suffer a distortion that is greater than necessary. The permanent increase of the budget deficit necessarily leads, sooner or later, to increasing inflation. In a recession or, in the currently applied means for financing it, it will come sooner rather than later. The method suggested for broadening the range of instruments is basically aimed at improving information for the economic agents, and creating economic policy instruments.[42] These are market-oriented, suitable for influencing events, and more effective than those applied at present. The former mitigates uncertainty and increases the time horizon of the actors, and the latter allows the regulation of the economy by using more refined instruments than the present ones, and causes lesser distortion. *Our concept relies basically on the adjustment of economic agents, and deals with the questions of both stabilization and growth.* It wishes to create the conditions for these, in short run, by economic policy measures. For the same purpose, the proposition includes certain fixed capital investments which currently can only be carried out by the state.

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[42] Although a different approach, similar thoughts are expounded by *Lányi* (1991).

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THE HISTORICAL MISSION OF HERESY
György Péter, the reform economist

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The study concerns the work as an economist of an outstanding pioneer of concept of the Hungarian reform. The article compares the initial ideas contained in György Péter's studies and the official reform decisions with the way they were implemented between 1968 and 1989. He establishes that the reform blueprints were basically put into practice, but failed to have the expected results: the system that came into being proved not to be stable or lastingly viable. The failure was not due to faulty implementation, but to a contradiction inherent in the ideas. The final part of the article underlines the great part played by the heretical ideas of György Péter in eliminating the old dogmas and stimulating new thinking.

György Péter is among Hungary's unburied dead. Though he died in 1969, the last intellectual and moral tributes have never been paid to him. Though he was a significant and influential personality, no definitive analysis of his work has ever been made. This is a longstanding omission, and it is high time to make up for it.

A self-contradictory career

György Péter's career was self-contradictory. It contained alternate periods of light and darkness, and included both transgressions and useful deeds.[1] He started out as a young man with a pure faith. He made great sacrifices and spent several years in prison for the communist ideas that later brought grave misfortunes to Hungary and to their own advocates.

He acquired great power when in 1949 he was appointed as president of the Central Statistical Office. At that time this entailed serving a policy whose executors thought that the end could justify the means. György Péter resorted to bad means for bad ends. His measures did great damage to Hungarian statistics, and wrecked the promising careers of many talented members of the profession.

Later, a few years after his appointment as president, he began a process of reformulating his ideas. He switched to serving good causes and became one of the pioneers of enlightenment. Even though the spread of his ideas was obstructed, their influence was felt increasingly widely. He was among the driving forces behind

[1] See the study by A. B. *Hegedüs* (1992).

the revival of statistics, economics, sociology and demography. He also used his position to help many people in trouble after the defeat of the 1956 revolution.

Then came the bitter conclusion. He was not even permitted to fall in defense of his convictions, but attacked from behind on trumped-up pretexts and harried to death.

This, condensed into the life of one man, constitutes the fate of one major trend among the Eastern European intelligentsia, shown in its ultimate form, almost like a novel.

The piece that follows is one of the studies presented as a tribute to György Péter by friends and admirers at a scientific session devoted to his work.[2] It singles out just one of his many activities, although possibly the most important and lastingly influential of them: György Péter's contribution to the economics of the economic reform.[3]

"Speak good of the dead, or not at all," the saying goes.

The rule has not been kept in this study or in the other contributions at the session. Our intention is not to canonize and glorify György Péter, nor do we consider ourselves as moral censors judging and condemning him.

I feel respect and friendly affection for György Péter, and I have much to thank him for. Nonetheless, rather than describing my personal memories of him, my intention here is to analyze objectively his economic views and the influence they had.

I approach his work from two angles, first in terms of economic history, and then from the direction of intellectual history. In the first part of the study I compare Péter's views with the actual Hungarian reform. I deliberately divorce Péter's ideas from their contemporary intellectual environment in this section of my analysis, confining myself exclusively to the question of how far they proved workable or to what extent they failed.

The second half of the study then restores Péter's work to its contemporary context, enquiring what influence his writings had on the thinking of others.

[2] Two lectures were given at the session, held on April 24, 1992. András B. Hegedűs (1992) spoke on the career of György Péter, while the author analyzed in this study Péter's work as an economist. The invited contributors were Rudolf *Andorka*, György *Borsányi*, Judit *Gelegonya*, Péter *Kende*, Pál *Köves*, Mrs. Aladár *Mód*, Sándor *Nyíri*, György *Péteri*, László *Szamuely* and Szabolcs *Vígh Mike*. The subjects covered in the contributions included Péter's pre-1945 communist past, his work on statistics, sociology and demography, his activities as a teacher and head of a government office, and the still unexplained circumstances of his death. The full text of the session is likely to appear in book form; meanwhile the authors are also publishing certain materials in periodicals.

[3] See his two main pieces of writing (1954; 1956).

Market socialism: blueprints and implementation

Péter's first reform article appeared in the journal *Közgazdasági Szemle* in 1954. In fact a few forerunners of his 1954 ideas can be found in his earlier writings, but in a much paler form, and so I will refrain from discussing them here.[4] Péter certainly has priority among the economists of the socialist countries insofar as he was the first to put forward a comprehensive idea for reforming the whole of the economy. Regrettably, his works never became known to the vast majority of Western experts, who usually cite the proposals published in *Pravda* in 1962 by E. *Liberman* (1962) as the most notable pioneer of the idea of reform. In fact György Péter long anticipated Liberman in time, and surpassed him in the depth and comprehensiveness of his ideas.

The preparation for the economic reform took place between 1964 and 1968 on the basis of the resolution of the Hungarian Socialist Workers' Party (HSWP) Central Committee. The *reform blueprint* officially endorsed by communist party and the administration was prepared.[5] In 1968 began the *historical realization* of the blueprint and along with it the stage I refer to in this study as *reform socialism*. This lasted until 1989, in other words right up until the political turning point with the change to a multiparty system.[6]

Two subjects must be discussed. First, the 1964–68 blueprint for reform is compared with Péter's concept. Secondly, the actual historical realization of the reform in 1968–89 is compared with the antecedents of it: Péter's ideas and the official blueprint.

On the first subject. The official 1964–68 blueprint for reform is very close to Péter's concept. The kinship is apparent in the specific content of the official blueprint, the measures proposed. Moreover, there is a similarity of spirit in the rhetoric as well, and the style, the method of argument, the rhetoric of documents that prepare for social changes count for a great deal. It should be remembered that the 1968 party document itself is more of a mobilizing instrument for the application of the reform, preceding a large number of legal regulations and specific directives for implementing it. To draw an artistic analogy, Péter's two articles can be likened

[4] György Péter's scientific career is described comprehensively in Judit Gelegonya's so far unpublished book (1990), which subjects all his economic works and the debates sparked off at the time by his writings to careful analysis. I have made use of Judit Gelegonya's work at several points in this study, for which I would like her to express my thanks.

[5] The most important document concerned is the HSWP resolution of May 25–27, 1966, the contents of which were summed up in a book published for internal use that came to be known among economists as the "yellow-brown book", after the color of its cover. This is the document I mainly have in mind when I refer in what follows to the "blueprint" for the reform.

[6] The most important comprehensive studies of the history of Hungarian reform economics: I. T. *Berend* (1990), J. Kornai (1986), J. M. *Kovács* (1990), I. *Pető* and S. *Szakács* (1985), and L. Szamuely (1982; 1984).

to a first sketch, outlining a work in a few pencil strokes; the official blueprint is the final sketch, already including much detail; then comes the work of art itself.

In what ways do Péter's initial draft and the official final draft coincide? Both propose abolishing compulsory planning directives. This is the kernel, the most important element in Péter's concept. Both recommend greater independence for firms and place firms' profits to the fore. But neither includes a final abolition of planning. They particularly want to retain planning and central control of investment and foreign trade.[7]

Apart from this agreement between the initial and the final drafts on economic coordination, there is full identity between them on two other basic ideas:

1. Public ownership, primarily state ownership, of the means of production was to remain. Péter made not the faintest allusion in his writings to the idea of privatizing state property. He wrote nothing about the possibility of authorizing the private sector; he did not press for any development of it, even as a modest adjunct to the state sector. Moreover he firmly rejected all forms of workers' self-management.[8] So ultimately, both Péter and the official reform blueprint of 1964–1968 took the prevailing system of property relations to be axiomatic.

2. Péter attached no political conditions of any kind to the implementation of his ideas for reform. In other words, he assumed that political structure pertaining at the time he wrote the study—the communist party's political monopoly and the interpenetration of the party and the state—would remain. This is another feature common to the initial version he drafted and the final official blueprint.

Two important ideas of Péter's were dropped from the official blueprint for the reform.

One was his proposal for "market-clearing prices"—prices that produce equilibrium between supply and demand. This does not feature among the basic principles of the official blueprint for reform.

The other idea dropped was Péter's notion that competition, or more precisely, competition among the sellers for the buyer, should become the motive force behind the operation of the economy. This was to replace the previous situation characterized by the buyers' competition for the favour of the seller. There is an essential difference from the model most commonly mentioned by Western writers as the intellectual antecedent of "market socialism". This frequently quoted model was devised in the 1930s by the great Polish economist Oscar *Lange* (1936-37). In Lange's market-socialist economy, the market is merely simulated by official measures. Péter was proposing real live competition: a supply surplus would have

[7] Péter recommended that firms be given full autonomy for simple reproduction, but he wanted to assign investment in its entirety to central control. The official blueprint went further, agreeing to a partial decentralization of investment decision-making.

[8] Judit Gelegonya's study, mentioned earlier, gives a detailed account of how Péter protested at the meetings of the reform committee formed after 1956 under the leadership of István Varga against the idea of applying workers' self-management in any form.

to be created on a macroeconomic plane as well, so that the producer-sellers are *compelled* to compete with each other if they want to utilize their capacity adequately. To that extent his concept of the market is far more realistic and lifelike than Lange's. But it must be added that this important theoretical innovation of Péter's was essentially omitted from the official blueprint of 1964–68.

On the second subject. Let us now compare the two drafts, György Péter's and the official blueprint, with the historical realization of the reform. The drafts were basically applied, but the results were far short of what the advocates of the reform expected. Moreover the reason, in my view, why the performance fell short of the expectations was not that the implementation departed essentially from the blueprint. On the contrary, the reform was less successful because the blueprint was substantially realized—the blueprint itself contained serious internal inconsistencies in the first place. Although the reform also had some favourable effects, these were undermined by the detrimental effects of the internal contradictions.

I must draw attention to the fact that this statement differs sharply from the position taken by many reform economists, who emphasized in the meantime, in the 1970s and 1980s, and continue to assert afterwards that the concept behind the reform was fundamentally correct, and that distortions slipped only into the application of it, mainly due to the resistance of the reform's opponents.

My line of argument is expressed in more detail in other works of mine.[9] Here I will only sum up the main points briefly, beginning where I ended the discussion of the first subject, with the question of *competition*. György Péter advocated real competition among producer-sellers, but for this free enterprise is indispensable. There is true competition only if anyone is free to enter a particular market, in other words if the producer-sellers operating already do not hold a position guaranteed by the state. But free enterprise and free entry into the market are impossible without private ownership. Establishing firms on a basis of bureaucratic decisions is clearly no substitute for this.

Still on the same subject, there is no real competition without winners and losers. Real competition is not for peanuts. The competitors are stimulated by the prospect of great rewards for the winners and annihilation and forced exit for the losers. Winning and losing on the economic plane is a matter of life and death. But there is no question of this in a reform socialist economy. The winners surrender their "excessive" profits, which are given to the losers so that they can survive. A lossmaking firm can rely on the state bailing it out time and again.

In connection with competition I mentioned the problem of *property*. Without private property, firms have no real autonomy. The American economist W. G. *Nutter* rightly termed as the "Grand Illusion" of market socialism the idea that it could bind the firms in state ownership to one another and to households via

[9]Principally in my new book (1992a), which is due to appear in Hungarian in the winter of 1992. See also my study (1992b).

market connections.[10] In the discussion of this area, the rhetoric of reform economics is replete with Orwellian "double-talk" and dialectical quibbling. Let firms have independence, but the state remain the owner. In other words let them be independent of state ("independence"), yet depend on it as well (for the owner can dispose over the income from his property and appoint and dismiss its leader).

This ties in closely with another cardinal principle of the reform drafts: conservation of the *political structure*. Péter implicitly assumes in his writings that an ideal coexistence between the party-state bureaucracy and the firm will develop. It will be a bureaucracy capable of exercising self-restraint, intervening in the workings of the economy only when it is absolutely inescapable, and even then in an objective and professional way.

But the reality differed markedly from that ideal situation! The actual sociological environment around the "market socialism" introduced in the socialist countries bore these characteristics:

— There is interpenetration of the party and the state.

— The economic sphere does not even have relative autonomy. It is subordinate to politics and its strings are pulled for political purposes.

— The bureaucracy of the party-state cannot resist the temptations of power. There are a million interventions in the economy.

— The management of a firm is not independent; every member of it belongs to the hierarchically organized bureaucracy. Their appointment, promotion and dismissal depend on their superiors, not on their business performance in the market.

— A firm is wholly dependent financially on the central organizations of the state.

The concept of market socialism expressed in both Péter's initial draft and the final official blueprint is based on false sociological premises.

The result is well known from the critical literature on reform economics, and a few words will suffice as a reminder: "manual piloting" of the economy, endless bargaining between superiors and subordinates, the ambivalence of "neither plan nor market", and the weakening of state and financial discipline. A causal connection can be shown between the slackening in the wake of the reform on the one hand, and the progressive disintegration of the macro equilibrium (accelerating inflation and indebtedness) on the other.

I would certainly not like to paint a onesidedly negative picture. The economic reform produced a great many achievements.[11] More will be said about these

[10] This criticism already appeared in the work L. von *Mises* wrote in 1920, and was then given great emphasis in the works of *Hayek*. Mises's study and Hayek's often quoted criticism of O. Lange's model of market socialism can be found in F. A. Hayek, ed. (1935).

[11] A substantial proportion of the achievements in the period 1968–89 can be ascribed to the fact that the formal and informal private sector began to develop. As we have seen, however, this phenomenon falls outside the concept of market socialism in a narrower sense, since it overstepped

in the second half of the study, but I will mention a few here as well. The greater independence made the economy operate more flexibly; the task of improving the quality of products came more to the fore. Still more important than the transformation of the economy was the change that took place in public morale: there was an end to the brutality of the command economy, the violence used to compell obedience to commands. Economic relations became more tolerable and civilized.

But important though achievements were, it cannot be denied that those preparing the 1968 reform had hoped for far greater success. Looking back on the 1968–89 reform period and comparing Hungary with other postsocialist countries, it can rightly be said that Hungary's decades on the road of market reforms gave it a better start, making it easier to begin the transition to a capitalist market economy based on private property. True, but the reformers of the 1950s and 1960s did not set out to prepare for conversion to a capitalist market economy! Their silence on the subject of a radical change in property relations and political structure was not tactical; they sincerely wanted to retain the earlier situation. Their aim was a *new stable system*, not a favourable *transitional* state. The trend of market socialism is one version of Third-Road philosophy. Its exponents thought the system created by the blueprint would be robust, able to consolidate and survive in the long term and ultimately superior both to the classical socialist system of the command economy and the capitalist market economy.

This wish did not and could never have come true. It was doomed like the other Third-Road concepts to fail sooner or later. Though the market socialist experiment lasted far longer in Hungary than in Gorbachev's Soviet Union, it proved to be a transitional period in the end. Instead of a robust, stable system, it turned out to be the specific institutional and political framework in which the disintegration of the socialist system took place.

Is it worth discussing?

Is there any sense in criticizing market socialism? Does the subject have any significance apart from being interesting as an episode in economic *history*?

Its historical importance in itself makes it worth studying. The attempt to reform the socialist system is one of this century's great undertakings. It must be discussed, and now, while the generation that took part in it is still alive and able to testify.

It should also be considered that reform socialism and the experiment with a combination of a communist political system and the market is still a reality today in China and the three countries of Indochina. This affects the destiny of more

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the intentions declared first by György Péter and then in the official blueprint, the "yellow-brown book".

than a billion people. That is something that those who speak of communism only in the past tense are inclined to forget.

And there is another topical aspect: the intellectual system analyzed in this study persists in an adjusted form in the period of postsocialist transition, among other places in Hungary. In another piece of writing I called it "anti-Bolshevik market socialism". Its line of argument can roughly be summed up as follows:

"The communists failed in their attempt to run state-owned firms along market lines. Now we will show them! We will retain a large state sector and withdraw it from the sphere due for privatization. At the head of these firms, we will place our own people. Once they are in our hands, they will operate efficiently!"

This line of thinking rests on similar illusions to those of market socialism under communist-party rule. Similar problems would arise. There would be a "politicization" of the economy, for instance—advancement of party interests at the expense of professionalism. There would also be artificial sustenance of firms in trouble, and paternalist protection of them from competition from the private sector and imports.[12]

The theory of market socialism survives, though with different rhetoric, and so there is still a point in criticizing it.

The influence of the heretic

Everything expressed so far in this study as a criticism of the theory of market socialism invites a retort: it is easy to be clever after the event... Let me add a personal comment here. When I wrote my work *Overcentralization in economic administration* in 1955–56, I myself fell into the same theoretical traps as György Péter. That is why in my writings I called him, myself at that time, and a good many others "naive reformers".[13] So let us jump back 38 years, from 1992 to 1954–55. Let us imagine ourselves in the intellectual environment in which Péter's writings appeared.

The dominant view, in economic policy and the teaching of political economy alike, is Marxist-Leninist-Stalinist dogma. Western economics is familiar to only a

[12] In my view the key question is the *ratio* between the state and private sectors. State-owned firms can be forced more or less into market and profit-oriented behaviour, although it will not be entirely consistent, only if the private sector has become dominant in the economy as a whole and the extent of the state sector has been dwarfed by comparison. Another requirement is that the state-owned firm should not enjoy a monopoly.

[13] See the new preface to the second, 1989 edition of my book *Overcentralization in economic administration*. I dedicated that second edition to the memory of György Péter. I can never forget that when the book was being sharply criticized after the first edition and its author branded an "ideological preparer for counterrevolution", Péter wrote a warmly appreciative review of it, and with the irony so typical of him, had it published in *Magyarország*, the weekly backed by the Stalinist faction of the communist party.

handful, who lie on the periphery of intellectual life and have no influence on it. All those active in the economy and economics teaching and research self-evidently accept the official ideology, without private reservations. *This* is the climate of public thinking on which György Péter's work bursts.

I think the aptest description of his personality is to say he was a *heretic*. His role resembled the one played by the heretics at the time when the Middle Ages were breaking up.

A dogma is a curious intellectual construct. It rests on a small number of axioms, perhaps only three or four, and these cannot be questioned. One such axiom in the dogma of the socialist system, can be summed up in a popular form like this: "The market is bad, the plan is good." The market means anarchy, and leads to crisis and waste. The plan, on the other hand, marks the triumph of human intellect; it is one of the main guarantees of the socialist system's superiority over the capitalist system.

This dogma's influence is not confined to the rational minds of its believers; it works on a meta-rational plane as well. Convinced Marxists not only view the market critically, they despise and abhor it as well.

György Péter attacked this cardinal dogma, this pillar of the official ideology. And as every axiom has a fundamental significance, anyone who abandons this axiom tends to reconsider the others as well. One of the bishops conducting the enquiry in László *Németh*'s play about the great Czech heretic John Huss remarks, "You cannot break one link in the chain of Christian teaching without the rest snapping as well."

A similar charge of causing a destructive chain reaction was levelled after the defeat of the 1956 revolution by László *Háy*, Géza *Ripp* and Endre *Molnár* at Péter and his revisionist colleagues: they begin with the market and rejection of plan instructions, and end by opening the way for capitalism. That counted as a capital crime at the time. We can now see that in fact they were right, so far as the content of their statement was concerned: those who truly begin to sympathize with the market really do open up the road to capitalism—even though that was not Péter's intention at the time.

It is worth saying a few words about the specific mission of heretics in the history of ideas. Whatever the idea, its influence depends not only on its content and how true it is, but on *who* utters it. Mises and Hayek, in fact, knew what the problem was with the socialist planned economy much better than Péter did, but who paid any heed to them in the Hungary of the 1950s? For Mises and Hayek, as declared enemies of socialism, were clearly prejudiced against the fundamental institutions of the system.

György Péter, on the other hand, had *credibility* among the economists of the time, precisely because he was an old communist who had even suffered imprisonment for his communist activities. He could not be assumed to be guided by prejudice in his criticism of the system. He had credibility, because he expressed himself in the "soc-pol-econ" idiom and the rhetoric of the communist party. His quotations were taken not from Western economists but from the classics of Marxism and the leaders and valid resolutions of the party. Think again, for a moment, of a medieval heretic. He would normally be a priest, conversant with theology, and expressing himself in the language of the Bible and the liturgy of the day. That is why he had credibility.

Let me mention a more immediate example from modern economics. Keynes was anticipated on many questions by the brilliant Polish economist M. *Kalecki*. Kalecki was a revolutionary innovator, yet his scientific achievements remained almost unnoticed at the time. What member of the profession's dominant group, the circle of Anglo-Saxon economists, would pay attention then to an obscure Polish researcher? Keynes was the man who revolutionized economic thinking, and his influence can be explained not only by the content of his ideas, but by the fact that he worked in Cambridge, England, the center of the economics profession in those days, that he was well known in political circles and lunched with the prime minister, that he belonged to the famous Bloomsbury Group of intellectuals, and that he expressed himself in the idiom of the profession.[14]

György Péter has been reproached by posterity for belonging to the privileged stratum of the communist regime. That is true. He happily travelled to Geneva and Vienna, and gladly sat behind the wheel of his official Mercedes. True, but he was not the only one to do so. Other high-ranking caders also enjoyed going to the West and travelling in a Mercedes. The difference was that Péter began to consider why a Mercedes was better than a Soviet-made ZIL. He not only shopped in Western department stores, but pondered on the reason why the range of goods in GUM in Moscow or the Corvin department store in Budapest differed from the range in the Grand Passage in Geneva. Perhaps it was not accidental; perhaps it had something to do with the arrangement of the economic system. While other caders bought their Bally shoes in Geneva, returned home and continued to laud the planned economy, Péter had the courage not only to acknowledge the difference between Swiss and Hungarian shoes, but to declare that there were deep, system-related reasons for the difference.

Although György Péter was a significant personality, I would not like to compare him with the "greatest Hungarian", the 19th century reformer István Széchenyi. But on a smaller scale he bore a clear similarity to Széchenyi in at least one respect. Széchenyi was an aristocrat, like other aristocrats travelled abroad more than once. He saw banks in England and went to horse races, as other aristocrats did. The difference was that he thought about his experiences, pondering on them profoundly and profusely. In the end he declared the painful truth: this country was backward; the state of its economy had to be changed; the Hungarian

[14] Keynes's personality and social standing are presented in two outstanding biographies: R. *Harrod* (1972) and R. *Skidelsky* (1986).

credit and transport systems needed developing and the institutions of the economy bringing up to the standards of the age. György Péter was also described frequently as a real socialist "aristocrat".[15] But as a travelling "aristocrat", he absorbed his experiences of the greater development abroad, gained insight into the backwardness of this country, and tried in his own way to shake his compatriots up.

The disillusioning and awakening effects of the idea of reform

The old system in Eastern Europe and the Soviet Union has broken up, and a new one is in the making. There is more than one group that claims exclusive credit for this, but in fact the great change resulted from the combined effects of several factors. One of the most important factors was a catharsis inside the leading stratum of the old regime. Their faith in the system collapsed, their system of values became uncertain, and with that, their hearts and minds became ready to accept the new values. This process of disintegration was an indispensable ingredient in the crisis of the socialist system and its subsequent collapse. And on examining this process of ideological decay more closely, it becomes apparent how great a role in it was played by the disillusionment, spread by the reform economists, with the old style of planned economy.

I underlined in an earlier part of the study how reform economics, along with its main trend, the idea of market socialism, failed to produce a Third-Road system that would prove to be stable. But although it did not achieve that, it proved to be a great training school, opening the eyes of thousands and thousands of economic leaders and economists and accustoming them to think in market terms. If Hungary today is better situated economically than most other postsocialist countries, the reason very largely is that so many people went through this training school. So we can be grateful to György Péter, who laid the foundation stone of this school and was the first to start teaching in it.

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[15] A. *Hegedüs* called him a "grand seigneur" in a newspaper memoir (*Magyar Hírlap*, November 3, 1990).

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IS RENTAL HOUSING NECESSARY? HUNGARIAN PROBLEMS IN THE LIGHT OF EXPERIENCE ABROAD

ZS. DÁNIEL

The experts dispute widely about the future of the public rental housing in post socialist countries. One position is that public rental housing should be sold to the sitting tenants. The paper discusses the disadvantages and problems of this kind of privatization.

The author—among others—opts for preserving most of the rental housing sector with gradual privatization. Her recommendation is a steady rise in the proportion of private ownership. There should be a profit incentive for individual entrepreneurs and institutions purchasing rental dwelling at market prices. The rents of public housing should rise gradually to the market level and rent controls should cease in the foreseeable future. The system of housing subsidies should be transformed with distinction between subsidies for the transitional period and forms of permanent housing assistance based on welfare considerations.

Point of departure

There is a crisis in Hungary's post-socialist housing management. Although the measures taken in the last two-and-a-half years point largely in the right direction, they have not had the expected effects on the operation of the housing sector, and in some cases they have caused new tensions. Among the explanations for this is that they constitute isolated measures rather than a new, comprehensive housing-policy. The debate among experts with often diametrically opposed value priorities and outlooks on housing policy has not yielded a consistent strategy that accords with the transformation taking place in the economy.

The rate of housing construction has fallen dramatically (see *Table 1*). The total of 128,422 dwellings completed in 1989-1991 was 30 percent down on the previous three years, and hardly a tenth of that total consisted of rental dwellings financed by the state. There has been a continued fall in the stock of rental housing through the sale of public housing to tenants at well below market prices (see *Table 2*).

Two years after the ownership of rental housing passed from the central to the local government, the fate of some 400,000 dwellings in Budapest—about 50 percent of the capital's housing stock —is quite uncertain. The maintenance backlog on

I am grateful to B. McLean for translating the text which was originally written in Hungarian. I have received valuable comments from Robert Buckley.

Table 1

Financial resources of housing construction

(Number of units)

Years	Financed from state budget	Financed by households with state (bank) loans	Financed by households without loan	Total
1961-1965	104,128	103,417	74,811	282,356
1966-1970	121,995	147,632	57,803	327,430
1971-1975	148,675	235,456	54,007	438,138
1976-1980	162,245	256,232	34,238	452,715
1981-1985	81,483	280,931	7,270	369,684
1986-1990	28,947	239,622	3,883	272,452
1986	7,622	60,539	1,147	69,428
1987	7,769	48,609	822	57,200
1988	5,209	44,700	657	50,566
1989	4,886	46,061	540	51,487
1990	3,641	39,539	717	43,771
1991	8,807	24,357		33,164

Source: Központi Statisztikai Hivatal (1991).

Note: The classifictaion by souce of finance altered in 1991. Of the 8,807 dwellings built with state recources, 1,459 were completed by local government, 100 by central budgetary agencies, 6,767 by commercial organizations (including the National Savings Bank), 461 by cooperatives, and 20 by charitable foundations and by other organizations.

this housing stock, worth HUF 625 bn is put at around HUF 100 bn. Moreover the local-government still lack the power to set rents, the rental sector makes a loss, and the condition of the housing stock deteriorates year after year. The problem is similar in other cities as well.

Having transferred its rights of ownership over rental housing, the central government considers itself exempt from subsidizing it any more, and so the state subsidy to the rental sector shrank to less than a fifth between 1989 and 1992. The local authorities have neither the financial resources nor the legal powers to reform the rental sector by placing it on a market footing and concurrently implementing an adequate social-welfare system of housing subsidies.

Housing expenditures are increasing. *Table 3* shows the housing related household expenditures and state subsidies in the public rental and the owner-occupied housing sectors. The 1989 data present a final snapshot of the distribution of financial burden between the household and the state in a reform socialist regime. Since, in course of post-socialist transition, in order to relieve the acute state budget deficit, subsidies to rents, interest on construction loans granted in the previous regime, energy for heating and lighting, and water and sewage services were reduced or removed. As a consequence household's expenses are rising.

Table 2

Privatization of public rental housing

	Number of privatized units Total	Budapest	Market value of Budapest units Million HUF/Unit	Selling price of Budapest units Million HUF/Unit	Thousand HUF/Sq.M
1988	8,729	1,602	–	–	
1989	18,711	5,558	–	–	
1990	54,023	22,156	1,681.2	259.8	5.4
1991	82,118	46,991	1,287.8	245.4	4.7

Source: For 1988–1989 figures: *Farkas* and *Vajda* (1990).
For 1990–1991 figures: Központi Statisztikai Hivatal (1992).
Note: An incentive to purchase a rented dwelling is provided not only by the sale price, equvalent to 15 percent of the market value, but by the fact that only 10 percent of the purchase price need be paid in cash, while the rest is paid in installments over 25 years at a fixed rate of 3 percent. It should be noted here that the rate of inflation, having been in double figures for several years, reached 30 percent in 1991 and would probably be about 25 percent in 1992.

One can foresee, that the ratio of housing expenditures to net income of households will not only reach but soon exceed the ratio prevaling in Western market economies (see last row of *Table 3*).

Bitterness and uncertainty prevails among a wide section of the public. The contraction of state housing construction and the sharp rise in the costs of private house-building mean that a high proportion of households without a home of their own have lost almost all prospects of obtaining one. After experiencing chronic housing shortage for decades, the Hungarian population has to face the problem of housing afforability as well. Many households are unable to pay the running costs of their housing. The bank that extends housing loans is owed a total of HUF 25 bn by 200,000 households, of whom a thousand have not serviced their debts for more than a year. According to figures from the firms that manage rented housing, unpaid rent in 1990 amounted to HUF 357.3 mn, as opposed to an aggregate rental income of HUF 7,204 mn, and HUF 566.0 mn as opposed to HUF 6,032 mn in 1991. The number of unpaid electricity, gas and district-heating bills has also increased.

Since new legislation is not in place the tenants of rental housing do not know who will be the future owner of the dwelling they live in or what tenancy conditions that owner will impose.

Many tenants buy their rental dwelling not because they want to become owners but out of fear concerning future uncertainties. They can afford the required cash downpayment and the monthly instalments but do not care for and cannot afford the future maintenance and repair costs. The local government has already

Table 3

Housing costs and state subsidies in 1989

	Rental public sector	Owner-occupied private sector
Direct housing costs:		
Tenant's expenditure, HUF/capita		
(rent, maintenance, key-money):	4,816	
State subsidy, HUF/capita:	5,922	
Owner's expenditure, HUF/capita:		
(New construction, interest on		
loan, property tax, maintenance,		
condo-fee)		9,634
State subsidy, HUF/capita:		8,803
Heating-electricity-water-sewage supply:		
Household's expenditure HUF/capita:	4,385	4,721
State subsidy HUF/capita:	3,042	2,782
Total household expenditure/ net income (per capita), %	11.6	19.0
Total state subsidy/ net income (per capita), %	11.3	15.4
Household expenditure plus state subsidy /net income (per capita), %	22.9	34.4

Source: The calculations were made by the author using the Central Statistical Office's 1989 Statistics on Households and the Finance Ministry's budget report and forecast.
Note: The target was to cut the central subsidies by 1992 to half their 1989 level. This was to include reductions from HUF 13.2 bn to HUF 1.4 bn in subsidies for the rental sector and from HUF 76.6 bn to HUF 61.9 bn for private housing construction. The HUF 28 bn of subsidies for energy, water and sewage services were to be abolished.

lost some of its valuable housing stock, because for political reasons it is hard for it to withstand public pressure to sell housing to its tenants on the previous terms, i.e. at well below its market price. According to a representative survey taken in Budapest in January 1992, the best-quality dwellings have been sold, amounting in Budapest to 20 percent of the stock.[a] Another 20 percent of tenants would be prepared to buy their homes under the same conditions, and a further 30 percent show an inclination to do so. Only 30 percent of tenants do not wish to buy, and they occupy the least valuable and worst equipped housing.

[a] *Hegedüs, Mark* and *Tosics* (1992).

The privatization issues does not simply concern households that live in rented housing. It has a bearing on the future housing management of local government. It influences the decisions of all who seek to enter the housing market in some capacity or other, for instance as the purchaser, and then owner, manager or occupant a building or dwelling previously owned and rented out by the state, or as the aspiring occupant of a rented apartment in place of the existence tenant at some time in the future. It greatly affects those weighing up the merits of various forms of investment, among them the prospect of buying a block of rental housing or a rental apartment for profit. Nor is the question immaterial to existing owner-occupiers of an apartment or house, the value of whose property depends on the supply, demand and prices prevailing in the real-estate market *as a whole*. So the legal and financial uncertainty surrounding the future of the rental sector presents a grave problem to all individuals and institutions concerned with apartments, houses and real estate. This study sets out to consider just two of the questions affecting the rental sector: 1) the place and role of the sector in the new housing system, and 2) the conditions required for households to adapt to it under the likely circumstances of the post-socialist transition.

The place and role of the rental sector

Rented housing, which is now in local-government ownership, still accounts for more than half of the housing stock in Budapest and other large cities. Experts differ widely over the future of rental housing. Their views can be simplified into two characteristic, mutually opposed approaches. Let me say at once that although the arguments behind the first position contain many aspects worth considering, I myself subscribe to the second.

The *first* position is fairly widespread among economists in this country and other previously state-socialist economies. The argument goes that the rental housing in public (state or local-government) ownership should be sold to its tenants, so that practically speaking, with the possible exception of a segment serving social-welfare objectives, the previous state-owned rental sector is wound up. The aim behind this is less to increase budgetary revenue through the sales than to reduce the future pressure on the central and/or local budget by having the state withdraw from financing the day-to-day running of the rental sector and the renovation of the delapidated housing stock. Another argument for this type of privatization is that the occupiers, as owners, will gain a direct incentive to renovate and maintain the dwellings, so that the privatization furthers the preservation of the housing stock, which constitutes a significant part of the national wealth.

These arguments are not without foundation. The idea of a certain fraction of the public rental sector, under certain conditions, to be transformed into privately owned condominiums should not be dismissed. But there are cogent arguments against allowing this form of ownership to become the exclusive or even the dominant one for multi-family housing units hitherto owned by the state. Without aiming at completeness, here are a few of the counter-arguments:

Table 4

Proportion of different forms of tenure

Owner-occupied		Rental		Other	
Country	percent	Country	percent	Country	percent
Ireland	70.8	Switzerland	68.8	Sweden	13.2
Spain	64.0	Netherlands	64.6	France	12.2
United States	62.9	Germany, Fed Republic of	64.1	Austria	12.0
Finland	60.4	Sweden	51.6	Spain	8.5
Canada	60.0	United Kingdom	50.5	Italy	5.0
Belgium	54.8	Austria	47.0	Norway	5.0
Norway	52.6	Denmark	46.8	Denmark	4.6
Italy	50.8	Italy	44.2	Switzerland	3.1
United Kingdom	49.2	France	43.1	Belgium	2.9
Denmark	48.6	Norway	42.4	Ireland	2.4
France	44.7	Belgium	42.3		
Austria	41.0	Canada	40.3		
Germany, Fed Republic of	35.9	Finland	38.5		
Netherlands	35.4	United States	37.1		
Sweden	35.2	Spain	27.1		
Switzerland	28.1	Ireland	26.8		

Source: United Nations Economic Commission for Europe (1980), pp. 80–90 and 270–271.
Note: Rental housing includes both commercial and subsidized "social-welfare" accomodations.

a) The rental housing sector has an important function in the operation of any market economy. This is clear from the appreciable size of the rental sector in the housing market of advanced industrial countries (see *Table 4*). Consumers want to choose among the housing alternatives according to their financial means and their requirements. One of the main choices is whether to live in an owner-occupied house or apartment, or whether to rent housing from others. In the latter case they receive neither the advantages nor the expenses and responsibilities of home ownership. Consumers making a choice between property acquisition or rental housing must be presented with realistic alternatives in terms both of expenditure and supply. On the expenditure side, this means that the discrepancies in costs between owner-occupied and rental housing must only express economically justified differences, not a state preference. As for supply, freedom of choice entails the absence of any shortage of rented housing and the availability of long-term credits on market terms to people buying or building their own homes.

Table 5

Homeownership rates by age in the USA / Number of households (In thousands)

	Owner		Renter	
	1974	1987	1974	1987
Age				
Under 25	1377	833	4666	4364
25 to 34	7630	9237	7042	11266
35 to 44	8653	12507	3412	9196
45 to 64	18590	20404	5731	5673
65 +	9593	14272	4160	4727

Source: Joint Center for Housing Studies (1989).

A household under a market economy may change this vitally important decision, even several times, in line with changes in its circumstances and the various stages in its life cycle. *Table 5* shows the connections between age and home ownership in the United States, while *Table 6* demonstrates the relations between income and home ownership in the United States.

Table 6

Household income and homeownership in the USA

	Number of households in thousands		Ratio: homeowner per total, in %	
Thousands of 1986 Dollars	1974	1987	1974	1987
Under 5	4,705	7,204	42.8	36.7
5 to 10	8,755	10,984	48.7	45.9
10-to 17.5	11,436	15,326	53.8	51.9
17.5 to 25	11,152	13,063	58.7	60.0
25 to 35	13,277	14,636	69.3	68.3
35 to 50	11,638	14,177	78.6	79.3
50 +	9,891	14,089	86.2	89.1
Total	70,854	89,478	64.7	64.0

Source: Joint Center for Housing Studies (1989)

The tables show that the share of households with an owner-occupied house or condominium grows in direct proportion to advancing age and income. Rental housing represents a more adaptable solution for young, geographically more mobile households at the beginning of their careers, both financially and in view of the uncertainty about future family size.

It is worth noting that 61 percent of American households under the age of 35 lived in rental housing in 1987, as opposed to only 26 percent of the same age-group in Hungary. (Rental housing accounts for 37 percent of the American housing stock and 25 percent of the Hungarian.) Similarly directed differences appear in the figures for income groups. According to the household statistics for 1989, which place Hungarian households in eight income categories, that only 19.4 percent of the households in the lowest income group live in rented housing, while 28.2 percent of the households in the top two income groups do so. The proportions found reflect that households are making a forced choice in a housing market marked by a distorted price system and a chronic shortage.[b]

The American example is particularly relevant to the present subject because it represents a more extreme case than the European market economies.[c] The federal and state housing policy in the United States is to encourage the construction and purchase of owner-occupied houses and apartments with income-tax relief on a significant scale, in other words to "intervene" in the market processes in order to expand the owner-occupied sphere. So the existence of a sizeable rental sector in the United States in spite of policy preferences to the contrary must be ascribed to a strong consumer demand on the market for rental housing, to which the supply is adjusted.

If one also recalls that home ownership is one of the symbols of the "American dream", i.e. that households are fundamentally intent on attaining the long-term security of their own property, the existence of a sizeable American rental sector is an additional argument for retaining a market rental sector.

The ratio of rental to owner-occupied housing differs from country to country, but in practice there is no modern large city without a sizeable rental sector. Hungarian cities need rented accommodation too, and a smoothly operating rental market can offer consumers freedom of choice.

In a 1992 opinion poll (taken by Medián Public Opinion and Market Research Ltd), 1,200 households were asked whether or not they considered their housing situation to be settled for the long term. The sample was divided into five age-groups, of which 51 percent of the 18–30s and 26 percent of the 31–40s rated their long-term housing situation as unsettled. The proportion in a settled housing situation rises significantly as a function of age in the groups above 41, where only 13 percent, 9 percent and 4 percent saw their housing situation as unsettled. With young households, the question of the choice between rented housing and owner occupation must be left open; they will make or flexibly change their decisions depending on their income situation, career development, job opportunites and family size. The availability of rental housing is an important part of encouraging labour mobility.

[b]See Dániel and Semjén (1987).

[c]Intervention on social-welfare policy grounds is disregarded here.

This opportunity to choose would be undermined and almost completely precluded for a long time if the "large-scale" form of the present rental housing (one "landlord", several tenants) is eliminated and replaced with the "owner-occupier" as the *exclusive* form of occupancy.

b) Also problematic is the question of maintenance and structural repairs. Privatization of the public rental housing would produce a form of organization similar to the present three-to-eight-unit condominium buildings. There is no disputing that many private condominiums are better maintained than the public rental buildings, but it is also well known that in Hungary legal requirement to form a common fund for the maintenance and renovation of commonly owned parts of the building is hardly ever complied with in practice. The case in a high proportion of residents' associations, which usually operate with majority voting, is that the majority, suffering from financial difficulties, votes against providing the financial means for the maintenance and renovation work due. So the conditions for constant maintenance and regular renovation are not created. Can the residents' associations formed after privatization be expected to treat the communally owned part of their property any differently?

The larger the building, the harder the problem becomes, because the residents becoming owners can be thoroughly heterogeneous in their financial circumstances and their expectations of their living environment. Almost 40 percent of the residents in rental housing are households of old-age pensioners containing no active earner. How can they be expected to bear the expenses of rehabilitation and renovation? Any condominium in a developed market economy usually operates as a voluntary association of households with more or less similar levels of income and expectations of their residential surroundings. The contract governing the condominium stipulates clearly what responsibilities the owners undertake: whether they consist of maintaining the facilities of the common property (roof, stairway, yard, garden etc.) in the cheapest possible way, or whether higher standards are set. Segmentation of the condominium buildings takes place, according to the level of the common charges. But the common charge that forms the common characteristic of the *house* really *has to be* paid, and this is ensured by law. This situation may develop in Hungary as well, so long as the private-condominium sector grows voluntarily and naturally. But it will not come about if the form is imposed on the residents of rental buildings. Earlier Hungarian experience, international evidence (see *Table* 7) and good sense alike warn that under the present social composition of tenants and the present quality of housing stock in Hungary the forced transformation of multi-family houses with more than 6 or 8 apartments into condominiums is a thoroughly dubious move.

Another argument against indiscriminately selling off rental housing is that the majority of buildings due for privatization have been neglected and need substantial sums spent on renovating them. This, however, is beyond the means of a

Table 7

Distribution of building-categories according to the number of units per building (in percentage)

	Number of units per building					
	1	2	3–4	5 or more	Mobile homes	Total
United States						
All units	67	6	5	17	5	100
Owner-occupied units	87	3	1	3	6	100
Rental units	31	12	12	43	3	100
Federal Republic of Germany						
All units	24	22	8	46	0	100
Owner-occupied units	56	29	5	10	0	100
Rental units	6	19	9	66	0	100

Source: Stahl and Struyk (1985).

significant proportion of the households concerned. A suitable solution for financing the rehabilitation has not emerged. But even if it had, it is doubtful whether long-term commercial loans or possibly income-tax or other fiscal concessions would provide enough incentive for the public to undertake further expenditure on top of their housing purchase, or whether there would not simply be a further deterioration in the housing stock once it was in private hands.

It is time to turn to the *second* position, to which I subscribe in common with another group of economists and sociologists.[d] This approach does not preclude the sale of some of the rental housing to sitting tenants at market prices in justified cases, but its point of departure is the long-term need for a significant rental sector operating on market principles. A gradual change in the property forms of the rental sector is considered advisable, with a growing part in the rented housing market being played by private ownership of rental apartment or whole rental multifamily buildings. In other words, the owner and the tenant in this sector should be separate. Each owner (an individual, a group of individuals, or institutional owner such as a pension fund or an insurance company) should have an express profit motive for purchasing or building rental dwellings. Some might buy one or more apartments in one or more buildings, without becoming the owner of the whole building.

Whether rental housing is municipally or privately owned, this is an activity that must take place on a commercial basis. In the case of the housing stock

[d]A considered and sober proposal for transforming the rental sector is described in *Hegedüs and Tosics* (1991). I basically agree with this concept, and I express proposals differing from it or differences of emphasis between us in a positive, not a polemic form.

owned by a local government, the management and operation of a building might be handed over to a private person or company, while the rights of ownership are retained. The private person or company would then become the head tenant with the responsibility of running and maintaining the building according to the contract, and enter into tenancy relations with the residents. Let me note here briefly that this proposal assumes there will also be social-welfare rental segment within the rental sector as well; I return to this later in the study.

Rent

Even among those who agree to the need for a rental sector, there is disagreement about what rents should be charged. It has been proposed, for instance, that a system of break-even, administratively controlled rents should still apply to part of the rental housing owned by local government, and only in another part of its housing stock, as with the rented housing in private ownership, should the rent be set by voluntary agreement between the owner and the tenant. This would mean that a dual system of rents applies. Partial rent control needs to remain for a transitional period so as to avoid any great disruption, but the transition should not be a long one. On its completion, rents based on voluntary agreements between owners and tenants should apply everywhere, and administrative rent control should cease.

It is clear from the decades of the socialist shortage economy and the experiences in the big cities of any capitalist country that state rent control breeds a housing shortage. Even partial rent control conserves shortage by deterring entrepreneurs from increasing the supply (see *Table 8*) and by preventing the constraints imposed by solvent demand being felt (see *Table 9*), so bringing about a permanent excess demand. Based on the example of several North American cities, experts on the subject warn that the longer the partial rent control remains in force, the greater the discrepancy between the levels of the controlled and the market-clearing, equilibrium rents becomes. (Downs 1988)

Numerous methods can be used to establish the desired equilibrium between supply and demand as quickly as possible. Rents at which it becomes profitable to build and run rental housing are needed. On the supply side, the construction of new rental housing must be encouraged, along with more intensive use of the existing stock of rental housing (for instance through rehabilitation and rapid renovation). On the demand side, there must on the one hand be subsidies provided for households that need them, so that they are capable of paying the market price for rental housing, while on the other there must be the appropriate conditions to encourage (but not compel) the public to acquire homes of their own in line with their means, so reducing the demand for rental housing.

Table 8

Annual average number of new multyfamily housing units built per 1,000 residents in each city

City	Before controls	After controls	Percent change
Berkeley	1.3	0.2	−84.6
Oakland	2.7	0.8	−70.4
Boston	3.6	1.7	−52.8
Los Angeles	3.4	3.9	+14.7
Newark	1.2	1.4	+16.7
San Francisco	1.9	1.3	−31.6
San Jose	3.7	2.3	−37.8
Washington D.C.	2.3	1.3	−43.5
Cambridge	5.2	0.5	−90.4
Santa Monica	5.1	2.2	−56.8
All 10 Cities	30.4	15.6	−48.7

Source: *O'Connor* (1987) quoted Downs (1988).
Note: The author draws a distinction between strict and loose rent control. He also points out that rent control led to the greatest fall in housing construction taking place in the two most strictly controlled cities, Cambridge and Berkeley. By contrast, only loose rent control could be discerned in Los Angeles and Newark.

The conditions for adaptation by households

If the aim is to place the operation of the housing sector on consistent market foundations, close attention must be paid to what the public can afford and tolerate. Disruption should be avoided, however, not by slowing the development of the conditions typical of a market economy in production and operation, but by helping households in difficulty to adapt to them.

The system of state subsidized rents rested on the assumption that wages would not cover the true social cost of housing utilization. But this earlier principle no longer applies in part, and is likely to become obsolete in a widening sphere. Significant differentiation of incomes has occurred in recent years, with the income of some groups multiplying several times over. This has applied to the earnings of high-ranking executives in state-owned firms and of some bank employees; the incomes of both business people in the private sector and private-sector employees have risen sharply; in very many cases "invisible" income is high. Meanwhile the incomes of other groups have stagnated or hardly increased at all. So the ratio of rent to income has come to differ very markedly among the various groups in society, some of which can afford the higher, market rents, and some not.

It is justified to require that the state should not give a blanket subsidy to the rental sector, since that represents a benefit also to households whose present

Table 9

Actual housing, declared demand and rent level

Rent level	1.	2.	3.
Actual housing quality sq.m.	104.7		
Declared demand quality sq.m.	153.3	142.2	124.0
Difference of declared demand and actual housing quality sq.m.	48.8	37.5	19.3
Ratio of rent cost of demanded housing/income percent	5.2	12.4	18.2

Source: Dániel (1989).
Note: The figures are based on a survey. The 1981 survey examined hypothetical market behaviour and demand under hypothetical rents. Rent Level 1 equalled the actual valid rent at the time of the survey, Level 2 an average of 2.5 times that rent, and Level 3 an average of 5.2 times that rent. Among the other facts to which attention was drawn in the survey was that an increase in rents to cost level (i.e. rent 3) could substantially reduce the housing shortage on the demand side, but not eliminate it, which would require an increase in supply, i.e. the adjustment must take place concurrently on the supply and demand sides. The subject is discussed in detail in Dániel and Semjén (1987).

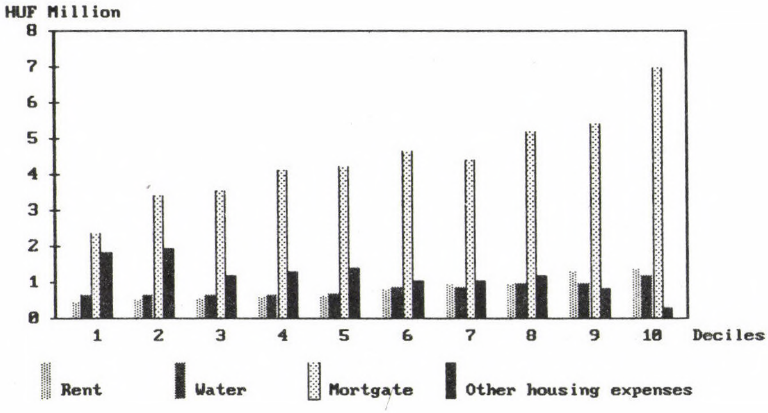
earnings permit them to pay a market rent. A subsidy to the *whole* rental sector self-evidently fails to direct society's assistance primarily to those in need of a subsidy.[e] (*Figure 1* shows the distribution of housing subsidies by income deciles.)

No less justified is a second requirement: that the state should not abandon those really in need of a subsidy. The state (by which I mean not only local-government budgets but also the *central* budget) cannot withdraw from subsidizing housing altogether, particularly not in the transitional period. The size and forms of state spending in two developed capitalist countries are illustrated in *Table 10*.

There are three groups entitled to receive some sort of governmental support for their housing:

Group One: Households are entitled to support where there is a delay before increased wages compensate them for the steady withdrawal of the subsidies and benefits in kind. So long as the housing expenses associated with conditions which are considered "fair" according to the norms of society exceed 25–30 percent of

[e]The problem is discussed in Dániel (1985).



Source: Central Statistical Office et.al. (1989).

Fig. 1

household income, it is desirable that they receive a subsidy equivalent to the excess expenditure.

Group Two: Low-income and/or socially disadvantaged households (old people on low pensions, large families, the sick etc.) are entitled to support if they are temporarily or permanently unable to afford the expenses of appropriate housing.

Group Three: Finally, the homeless are entitled to assistance. For simplicity's sake they can be placed in three groups: *a)* Those homeless for financial reasons, whose crises derive from their inability to find a home they can afford. (These also include those evicted from their homes, those made homeless by the closure of workers' hostels, and young people embarking on their careers who have been in state foster homes.) The feature in these cases is that their lives can return to normal once their housing problems are solved. *b)* Those whose homelessness is situationally induced, in other words due to other factors besides finance, such as a crisis induced by illness. *c)* The chronic homeless, mainly single people, who are on the peripheries of society and incapable of integrating into it. Although the problem in Cases *b)* and *c)* cannot simply be reduced to housing, access to subsidized housing in the framework of social welfare programs must certainly be one of the factors in assisting them. The municipality of Budapest estimates the number of its homeless at about 10,000 of a population of 2 Million.

Table 10

Government financial involvement in the housing sectors

Measures of involvement	United States	Federal Republic of Germany
Housing subsidies as a percent of government expenditures	1.0	1.1
Housing subsidies per capita, in US Dollars	33.0	58.0
Subsidized households as a percent of all households	5.1	25.2
Tax losses as a percent of government budgets	5.0	3.0
Tax losses per capita in US Dollars	143.0	120.0

Source: Stahl and Struyk (1985).
Note: In the case of the United States, the government denotes the federal administration, while for the Federal Republic of Germany, it denotes all levels of government.
A 1% share of budget spending in Germany may represent a far higher absolute subsidy, because the government operation/GDP ratio is far high than in the United States.
The two countries differ not only in the scale of subsidy and number of recipients, but in the method of subsidy. Germany spent substantially more of its resources on housing subsidies than the United States. Two separate means of intervention took place in both countries—raising the purchasing power of households and reducing the price of housing—but in different proportions. US housing subsidies went mainly to tenants of rental housing, while those building or purchasing their own homes received tax concessions. Both tenants of rental housing and owner-occupiers in Germany received housing subsidies, while bigger tax concessions were given for the construction of rental housing than for individual house purchase.

The two forms of subsidy

In line with the transitional objectives and the ultimate situation envisaged, a distinction must be drawn between two forms of subsidization: *adaptation* and *social* subsidies. The financial cover for these would come partly from the central budget and partly from local-government housing funds—sales of dwellings and building sites and profitable management of the housing stock.

Adaptation subsidies are paid over a specific period and are phased out gradually. The period could be three to four years, since the process of economic and housing-market adaptation is slow. They serve the purpose of allowing the demand for housing to adjust to the actual income level without causing serious disruption for households. Those wishing to diminish the size of their housing consumption should have enough time to make the adjustment. Adaptation subsidy should be confined to households currently occupying rental housing and to young people wishing to set up a family and choosing the rented form of housing. According to the classification introduced in the previous section, Group One is the main recipient of adaptation subsidies.

Unlike subsidies for adaptation, *social subsidies* are not just needed for a transitional period, and will have to continue later as well. Groups Two and Three are recipients of this type of assistance. Their purpose is to support or raise the housing consumption of low-income and/or socially disadvantaged households. With careful social supervision, they can be given in various forms, of which I would like to mention just two. One is a direct, cash income supplement, wholly or partly "ear-marked."[f] The other is an indirect subsidy in which a tenant receives "social" housing at less than a market rent. The housing-management company should still be expected to collect a market rent in the second case, the difference being that part of the rent is covered not by the tenant, but by the governmental budget. The need for local-government housing provided on social grounds will certainly persist. The demand for it should be met not only from the current housing stock, but by adding more in-expensively constructed housing of the required standard. Despite the limited funds available, social housing is needed not only to remedy the situation of already homeless people and fragmented families, but to prevent a future increase in homelessness.

Western experience shows that each solution (producer or consumer oriented, direct or indirect housing subsidies) has advantages and drawbacks.[g] The choice of the appropriate form must depend on the state of the local housing market, the quantity and mix of quality in the housing stock, and the specific conditions under which a family qualifies for a housing subsidy. The condition attached to social subsidies should be entitlement, not the property form of the housing occupied; in other words, social subsidies in cases of need should be available to households in both rental and owner-occupied housing.

To sum up, I recommend that the rental sector remain, with a steady rise in the proportion of rental buildings and dwellings in private (individual or institutional) ownership. If some of the present rental housing in public ownership is sold at market prices, the potential purchasers should not be confined to the sitting tenants: there should be an incentive for institutions and individual en-

[f] A noteworthy proposal is presented in Hegedűs, Struyk and Tosics (1990).

[g] The question is discussed in detail in *Mayo and Barnbroek* (1980) and Dániel (1988b).

trepreneurs to purchase and run blocks of several rental apartments. A segment of social rental housing should form within the rental sector. The rents of public (local-government) housing should rise gradually to the market-rent level, and rent controls should cease in the foreseeable future, so ending the differences in the operating and renting conditions under the various forms of ownership. That would leave the special treatment of social housing as the only exception. The system of housing subsidies should be transformed, with a distinction drawn between subsidies introduced for a transitional period and the forms of permanent social assistance. The transformation of the whole housing sector should be integrated into the overall process of humane transition to a market economy.

November, 1992.

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THE ASSOCIATION AGREEMENTS BETWEEN THE EC AND CENTRAL EUROPE: TRADE LIBERALIZATION VS CONSTITUTIONAL FAILURE?

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East European transition countries have liberalized their trade policy. The response of the European Community has been a soft support. The reason of this "softness" is that the Association Agreements are based on two different motives. On the one hand, they obey the motive of freer trade. On the other hand the Agreements materialize the EC commitment to unify for 1993 the trade policies of the EC member states vis-à-vis the CEECs.

Introduction

Since 1989, the so-called "Partners in Transition" (hereafter PIT) countries—the Czech & Slovak Federal Republic (hereafter CSFR), Hungary, and Poland—have unilaterally and dramatically liberalized their trade policy. The boldest trade liberalizations of the CSFR and Poland have led to three remarkable results: a border protection quasi-exclusively based on tariffs, low average tariffs ranging from 7 (the CSFR) to 14 percent (Poland), and the virtual absence of tariff peaks granting a non-discriminatory tariff liberalization to all OECD countries. As a result, border protection in the CSFR and Poland is now lower, more uniform and more transparent than that accorded to domestic producers in many OECD countries in the late 1980s.[2]

This paper examines how the trade policy of the European Community (hereafter the EC) which is the most important trading partner of the three PIT countries (in 1990, the EC has absorbed more than one-third of all the PIT exports) has reacted to these changes in the PIT trade policies.

Between 1989 and 1991, the EC (as all the OECD countries) has been slow to react and cautious—eliminating barriers on marginal exports from the PIT countries but maintaining crucial restrictions on all their major exports. This attitude of "wait and see" may be understandable, but its costs have to be recognized. The PIT countries engaged in dramatic trade reforms have been left without strong

[1]I would like to thank G. *Abel*, H. *Ergas*, D. *Henderson*, B. *Kalinova*, J. *Martin*, G. *Pohl*, R. *Snape*, D. *Tarr*, J. P. *Tuveri* and the participants of the Conference on "Eastern European Trade Policy Issues" sponsored by the European Bank for Reconstruction and Development (26–27 March 1992) for very helpful comments or discussions on previous drafts.

[2]The EC *ad valorem* equivalent rate of protection (including non-tariff barriers) against CEEC exports has been estimated to roughly 14 percent (*Aghion, Burgess, Fitoussi and Messerlin* 1992).

international support, more especially as GATT could not fully play its constitutional rőle because PIT countries are "imperfect" GATT Contracting Parties. As a result, the risks of "reversibility" of PIT trade policies have recently increased.[3] During 1991, they have materialized in the most protected sector of the OECD countries—agriculture—as best illustrated by the re-introduction of farm subsidies in the CSFR in mid-July.

The three recent Association Agreements signed in December 1991 by the EC and the three PIT countries (and enforced in March 1992) have often been seen as a dramatic improvement of the EC trade policy vis-à-vis the PIT countries. The wide coverage of the Agreements has induced many observers to present the Agreements as a big step to a "free trade area" between the EC and the PIT countries.

However, the detailed examination of the Agreements presented in this paper suggests a different view, based on the two opposite "faces" of the Agreements. In terms of *trade liberalization*, the Agreements ease access to EC markets for PIT exports, but largely by consolidating previous concessions. The major PIT industrial exports (apparel, steel, coal) will still face substantial EC tariffs and non-tariff barriers during the next five years and trade liberalization in agricultural goods—another crucial export sector for the PIT countries—is embryonic and uncertain. More importantly for the long run, the Agreements are loaded with provisions on *rule-making*—particularly, export quotas, safeguards and rules of origin—which foreshadow managed trade, undermine the announced liberalization, and underline the failure of the EC to act as the constitutional anchor for economically sound trade disciplines in Europe.

As the specific aim of this paper is to provide evidence supporting this view, the paper is organized as follows.[4] The first section presents the recent history of the trade relations between the EC and the PIT countries and it provides evidence supporting the crucial role of trade agreements for the PIT export performance. The second and third sections examine the trade liberalization measures concerning agricultural and industrial goods, respectively. The fourth section analyzes the potential impact of the rule-making provisions contained by the Association Agreements. The conclusion of the paper looks at the reasons which could explain the absence of a strong EC support to more open PIT trade policies.

[3] It is important to underline that the costs of the EC (and other OECD countries) slow reaction do not correspond to a "reciprocity" issue—the PIT choice for freer trade is optimal for the (small) PIT countries, even if the OECD countries do not grant concessions in exchange—but to a "reversibility" issue—helping the PIT countries to stick to the freer trade choice during the transition period.

[4] *Rollo* (1991) provides an analysis of the debates during the negotiation of the Association Agreements, noticing the first signs of the problems mentioned above. *Winters* (1992) and *Portes* (1992) who adopt broader approaches express the same concerns than those of this paper.

Section 1. The EC-PIT trade and trade agreements: a close relation

This section briefly presents the major aspects of the trade relations between the EC and the PIT countries since 1988, including the Association Agreements enforced in March 1992. Then, it provides two important preliminary observations. First, it clearly shows that trade agreements between the EC and PIT countries did matter in the recent past, independently from other economic forces (exchange rate fluctuations, proper functioning of PIT domestic markets, etc.). Lastly, the section describes the structure of the PIT exports in order to locate the EC trade barriers which count most for the PIT exporters.

1.1. A brief history of the EC-PIT trade relations (1988–1992)

The EC reacted to the dramatic changes in the PIT trade policies essentially by initiatives in terms of tariffs. In 1990, as the three PIT countries already benefited from the most-favoured nation (hereafter MFN) treatment by the EC, the EC added Hungary and Poland to the list of countries benefiting from the EC Generalized System of Preferences (hereafter GSP) for products eligible under this scheme and for a period of five years. In 1991, the CSFR was added to the list under the same conditions.

EC initiatives on "non-tariff barriers" (hereafter NTBs) have been much slower and more limited than initiatives on tariffs. A first initiative was embodied in the "Cooperation Agreements" signed between the EC and the PIT countries (between November 1988 and September 1990) which stated that quantitative restrictions for specified goods were to be eliminated in two steps, with a first—small—list of goods to be liberalized one year after the signature of the agreement, and a second list to be liberalized three or four years after. In November and December 1989, a bolder EC initiative aimed at eliminating all EC import quantitative restrictions which were specific to Hungarian and Polish exports and at suspending (on a renewable one-year basis) EC quantitative restrictions enforced against these two PIT countries as well as market economies. These measures were in force in 1990, extended (in October 1990) to the CSFR (and to Bulgaria and Romania) and renewed for 1991.

However, both the Cooperation Agreements and the following measures of elimination and suspension of quantitative restrictions explicitly excluded three PIT export sectors—agriculture, textiles and apparel, iron and steel. And they implicitly excluded a fourth PIT export sector—chemicals—by not changing the antidumping procedures (that is, by maintaining the special antidumping rules against non-market economies). As shown below, these four sectors are the major

PIT export sectors, so that the EC trade liberalization in terms of quotas concerned marginal PIT exports.

Negotiations about the "Association Agreements" between the EC and the three PIT countries were held in 1990–1991. The Agreements were signed in December 1991, and in order to avoid the delays due to parliamentary ratification, interim texts allow their enforcement since March 1st, 1992—as initially scheduled.

The Agreements have a wide coverage.[5] They consist in 124 Articles dealing with political dialogue and general principles (Articles 1–6), movement of goods (Articles 7–36), movement of workers, establishment, and supply of services (Articles 37–58), payments and capital, competition and approximation of laws (Articles 59–69), economic, cultural and financial cooperations (Articles 70–103) and final provisions (Articles 104–124). Moreover, they are accompanied by 18 Annexes and 7 Protocoles.

This paper focuses on the EC commitments and on the provisions aiming at liberalizing *trade in goods*—that is, Articles 7 to 36, their 14 Annexes and the four Protocols dealing with trade matters (textiles and clothing, steel, processed agricultural products, and rules of origin). These commitments are summarized in *Table 1*.[6]

1.2. The recent PIT export performance: trade agreements do matter

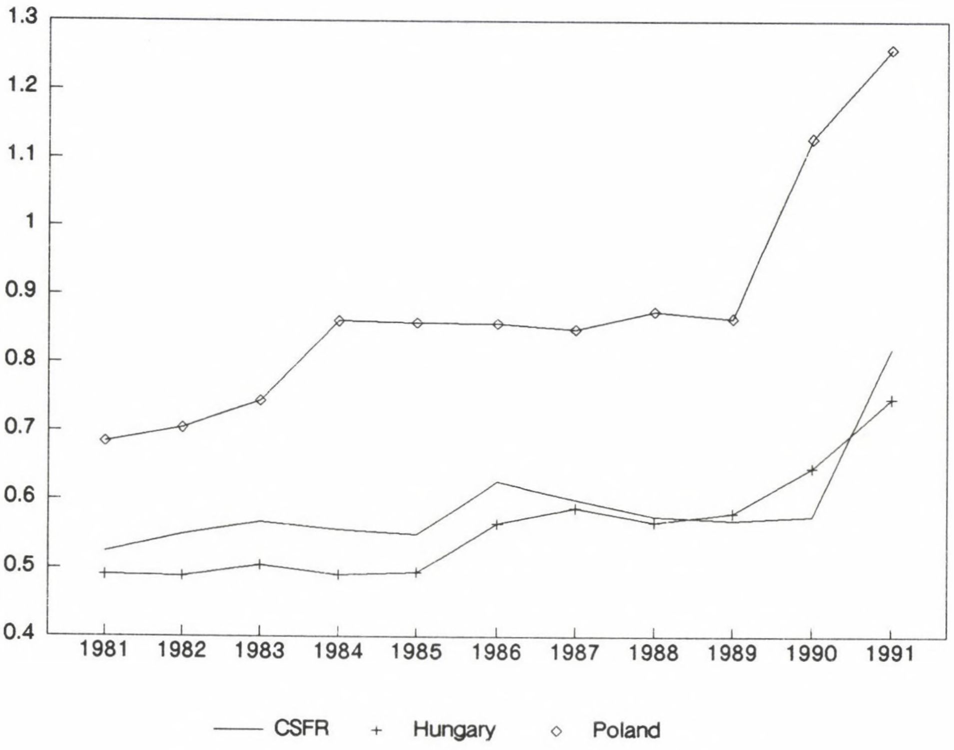
Graph 1 shows dramatic changes since 1989 in the shares of the PIT exports in total EC imports—in sharp contrast with their stability during the second half of the 1980s.[7] One may argue that these changes have been predominantly related to domestic factors. Indeed, this conclusion fits well with the fact that Hungarian exports to the EC have increased only in 1990—revealing an apparent incapacity of Hungary to take advantage of the Cooperation Agreement (signed in November 1988).

However, *Graphs 2:1* to *2:3* which present the PIT export performance on a monthly basis clearly show that *changes* in the EC trade policy did matter. First, the dramatic changes in the CSFR and Polish export performance in the EC markets coincide perfectly with the Cooperation Agreements and the EC decision to eliminate or suspend quotas. Second, to explain these changes by domestic factors

[5] The Section describes the Agreements on the basis of the EC-Hungary text (EC Official Journal, 1992, L116). The Agreements with the CSFR and Poland (respectively, EC Official Journal, 1992, L115 and L114) are similar.

[6] Winters (1992) analyzes the other aspects (services, factor movements, competition law, and financial aspects) of the Agreements.

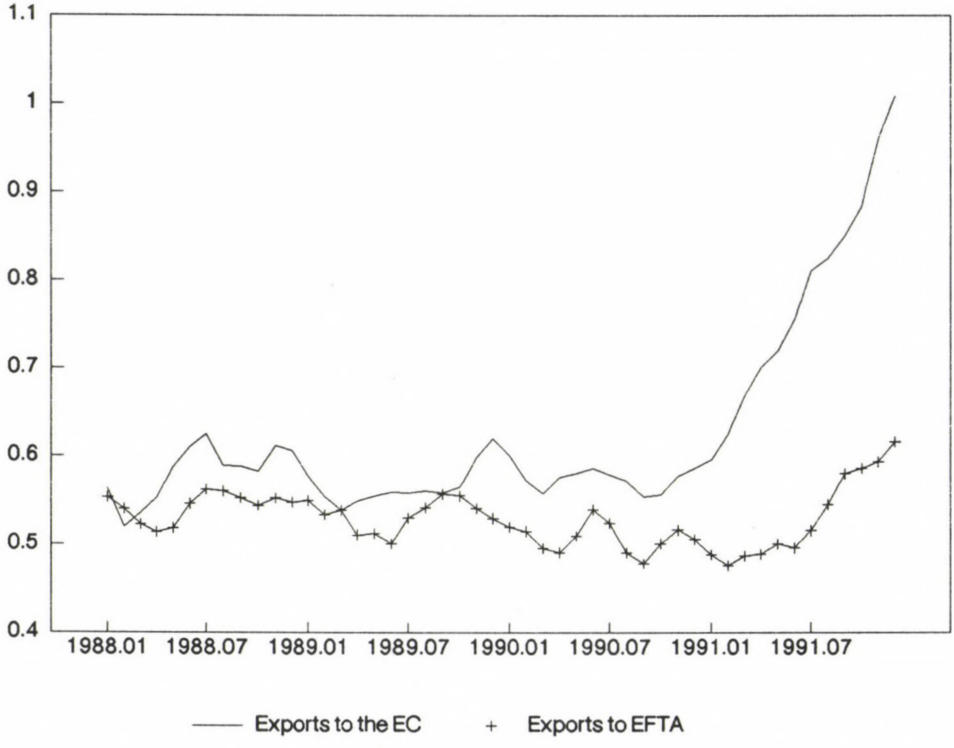
[7] The four Graphs examined below are based on PIT exports measured by EC imports from the PITs (OECD, *Statistics of Foreign Trade*).



Graph 1 PIT exports to the EC (in percent of extra-EC trade)

does not fit with the flat export performance of these two PIT countries in EFTA markets—a flatness consistent with the *stability* of the EFTA trade policy vis-à-vis these PIT countries.[8] If dominant, domestic factors would have created the same turnpoints in the CSFR and Polish exports to the EC and EFTA countries. Indeed, the CSFR and Polish exports to EFTA markets increased during the second quarter of 1991—when it became clear that the EC-EFTA negotiations on the European Economic Space entered in their final phase, leading to a catching up of the EFTA trade policy (relative to the EC policy) towards the PIT countries (that Hungarian exporters may have better understood this point may explain the shorter lag between Hungarian exports to the EC and EFTA markets). Third,

[8] In June 1990, EFTA countries signed a Declaration of Cooperation with the three PIT countries (the so-called Gothenburg Declarations). As EFTA-PIT trade was already relatively open (the only significant quotas concern textiles imported into Norway), the Gothenburg Declaration did not change substantial aspects in terms of EFTA industrial trade barriers. The EFTA-PIT agreements signed (CSFR) or to be signed (Hungary and Poland) in 1992 deal with tariffs and the few NTBs.



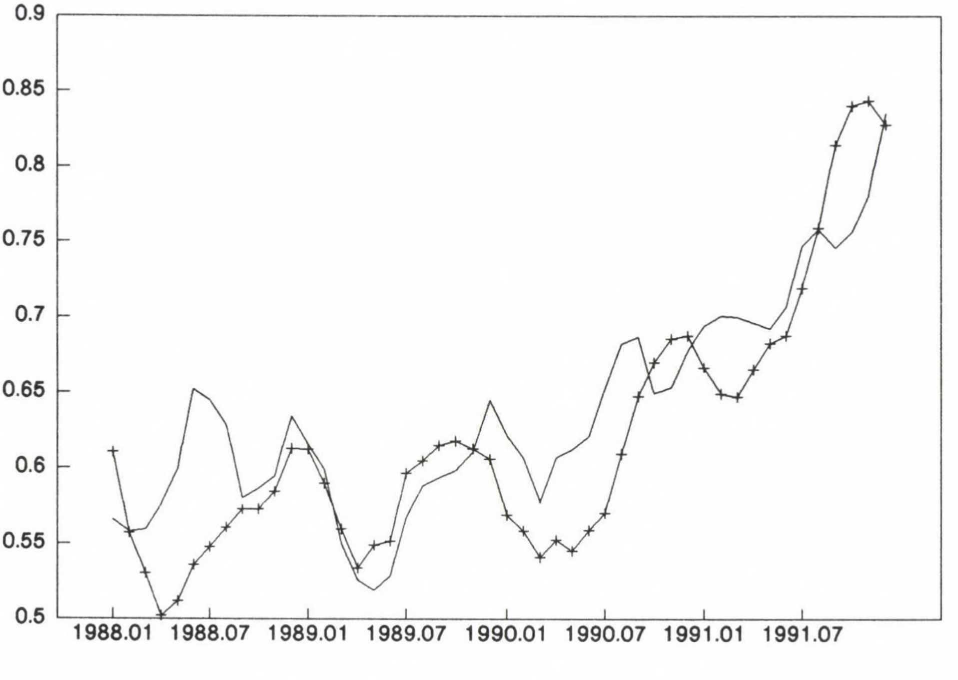
Graph 2:1 CSFR exports to EC & EFTA (percent of extra-EC or extra-EFTA trade)

the Hungarian exporters have strongly reacted to the EC decision to eliminate or suspend quotas—showing that this decision was much more important than the Cooperation Agreements.

That trade agreements between the EC and PIT countries did matter so clearly is not astonishing. In 1990, PIT exports to the EC represented 32 (the CSFR) to 38 percent (Hungary) of the PIT total exports, that is, 7.5 (the CSFR) to 11.7 percent (Hungary) of the PIT GDP, and, in 1991, PIT exports to the EC would represent 13 (the CSFR) to 19 percent (Hungary)—all figures which strongly suggest that changes in the EC trade policy are likely to have a large impact on the PIT economies.[9]

Graphs 1 and *2* deserve a last observation. The large increases of the PIT exports shown by these graphs have sometimes been interpreted as a sign that EC

[9]GDP figures for 1991 are computed from the GDP figures for 1990 (International Monetary Fund, *International Financial Statistics*, April 1992) and from the 1991/1990 annual changes in industrial production (UN Economic Commission for Europe, *Economic Bulletin for Europe*, volume 43, 1991).



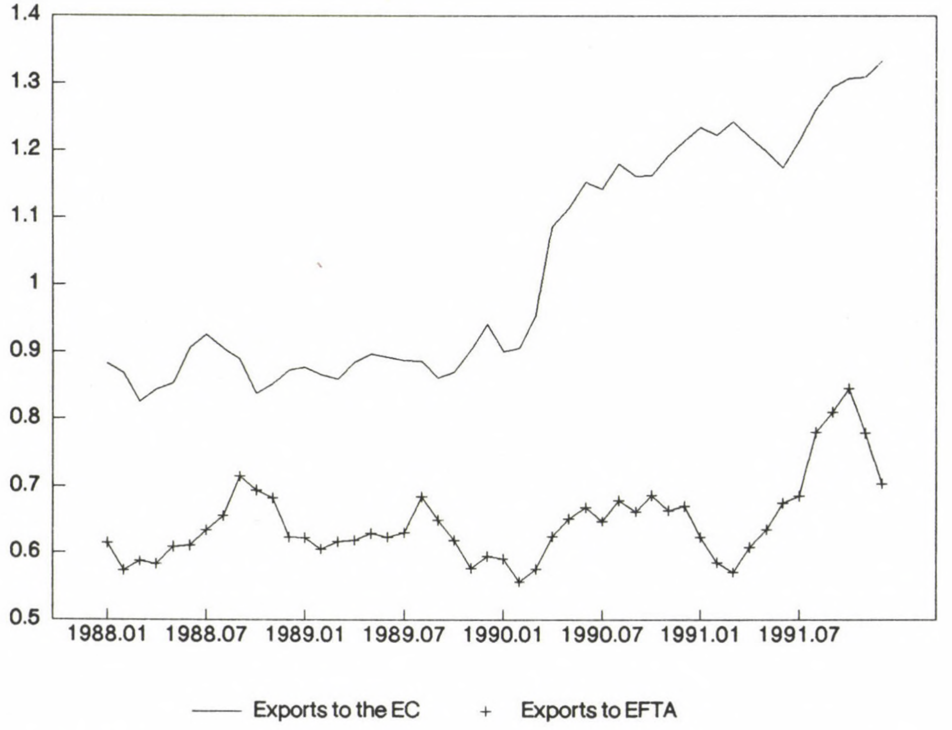
Graph 2:2 Hungarian exp. to EC & EFTA (percent of extra-EC or extra-EFTA trade)

trade barriers against PIT exports have a minor impact on PIT exports. Such a conclusion is incorrect. To say that EC trade barriers have a minor impact would require to compute the evolution of the PIT exports in the *absence* of all the EC barriers, to compare these "free trade" estimates to the *actual* increase of PIT exports to the EC, and to find no significant differences between the actual export performances and the estimates.

1.3. The major PIT export sectors

Table 2 shows that the PIT exports to the OECD are highly concentrated in a few sectors: energy (oil and coal), agriculture, textiles and apparel, iron and steel, and chemicals. Together, the four last sectors account for 36 (Poland) to 51 percent (Hungary) of the PIT exports to the OECD countries.[10] Moreover,

[10] There are no substantial differences between the structure of the PIT exports to the major OECD markets (EC, EFTA or more marginal markets, such as the U.S.).



Graph 2:3 Polish exports to EC & EFTA (percent of extra-EC or extra-EFTA trade)

these four sectors account for a large portion of the domestic value-added—from 23 percent (Poland) to 34 percent (the CSFR) of the concerned GDP.[11]

Table 2 also reveals how large is the mismatch between PIT exports of some importance (more than 3 percent of all exports) to OECD countries and to the other Central and Eastern European Countries (hereafter CEECs).[12] The magnitude of this mismatch suggests that the PIT countries have been induced to produce and export to the other CEECs goods for which they had little or no comparative advantage with respect to market economies. Under CMEA preferential market access rules, artificially cheap Soviet energy has inflated imports of Soviet energy

[11]These figures are based on four industries defined in terms of the International Standard Industrial Classification (ISIC): food manufacturing (ISIC 311), textiles and apparel (ISIC 321 and 322), chemicals (ISIC 351 and 352), and iron and steel (ISIC 371). Data concern the manufacturing sector alone (for the year 1987), and they are from *Industrial and Development Report: Global Report 1989/90 (UNIDO, 1989).*

[12]CEECs include the PIT countries, Bulgaria, Romania and the states of the former Soviet Union.

by the other CEECs, and through the rigid system of bilateral balances, it has inflated exports from the CEECs to the USSR. Crude attempts to realize scale economies have led to excessive fragmentation of production between the CEECs, and again to inflated trade. Long-term forces of comparative advantage under world prices is thus likely to impose a contraction of intra-CEEC trade.[13]

Comparative advantages of the PIT countries in an open environment remain largely unknown: identifying them will be the major task of PIT firms and foreign investors in the PIT economies in the future.[14] There are, nonetheless, three reasons for expecting these four sectors to remain central to PIT export growth over the medium to longer term. First, recent PIT exports reflect their existing industrial infrastructure, most of which will be still in place in the medium run, and will thus provide the bulk of the PIT export revenues for the first half of the 1990s. Second, these four sectors do have some—albeit limited because of generous export premium schemes—experience in exporting to OECD countries, having been present in these markets in the 1980s. Third, there are signs suggesting that the PIT countries are—in relative terms—rich in unskilled labour, raw materials, and in some types of skilled labour. As a result, their comparative advantage may be more robust for relatively labour-intensive products (such as subsectors of agriculture and apparel) and to a lesser extent for raw material-intensive products (such as subsectors of chemicals and to a lesser extent iron and steel) than for capital- (and skilled labor-) intensive goods (such as textiles and subsectors of agriculture and chemicals). As a result, the following sections of the paper focuses on these four sectors.

Section 2. EC trade barriers in agriculture

The PIT agricultural exports—85 percent of which are sold on EC and EFTA markets—are concentrated in three groups of products: live animals and meat (Poland and Hungary supply one fifth of the EC total imports of meat), dairy products (the PIT countries supply 10 percent of total EC imports of these products) and fruits and vegetables (although the PIT countries are not among the major suppliers of the EC and EFTA markets for these goods). However, as the EC agricultural markets are highly protected, import shares are highly misleading. Shares in terms of EC domestic consumption provide a more accurate picture. For instance, the PIT exports of live animals and meat to the EC represent less than two percent of the EC domestic consumption.

[13] In other words, the recent decline of the intra-CEEC trade is very likely to be more than a mere consequence of macro-economic programs of limited duration, transitory collapse of the Soviet economy or once-for-all changes in CMEA trading rules.

[14] For an economic analysis of this point, see *Hamilton and Winters* (1992).

The level of protection available for producers competing with PIT farm product exporters can be best estimated by looking at the "nominal assistance coefficients" computed by the OECD Secretariat and which provide a rough estimate of the wedges—created by all forms of agricultural assistance—between domestic and world prices on the exports of each PIT country on EC markets.[15] *Table 3* gives the OECD estimates for the EC, and it provides two crucial results. The level of protection faced by PIT exports is very high: in the most recent years, it exceeds 100 percent for most of the products—a situation which explains why EC farm support increasingly tends to be reinforced by quantitative measures. And, between 1985 and 1989, there was a substantial increase of the EC level of protection.

EC concessions on agricultural products (defined as items pertaining to Chapters 1 to 24 of the EC Harmonized System and to Annex I to the provisions on industrial products) are embryonic and uncertain.

The embryonic aspect of the EC concessions flows from the fact that they are granted within the existing system of quotas or tariff ceilings which will not be completely removed. The abolition of the "specific" quantitative restrictions at date into entry in force essentially concerns old protection maintained by certain EC Member State and they are not of major interest. When granted, increases of quotas/ceilings amount to roughly 36 percent (over four years, according to slightly declining annual rates). Such increases do not represent large portions of PIT exports, and they represent a minute portion of the EC consumption—meaning that they are unlikely to have any impact on the EC prices (if prices were allowed to fluctuate).

The uncertain aspect of the EC concessions in agriculture flow from the fact that EC levies are not eliminated, but merely reduced by a pre-determined percentage. That does not guarantee any decline in the EC protection to PIT exporters because the level of levies is an endogeneous outcome of the Common Agricultural Policy and of the world markets (that is, the agricultural policies of major other OECD countries). For instance, if they were granted in 1986, the EC "concessions" would have implied an increasing EC level of protection for the PIT exporters of meat since, as shown by *Table 3*, the 25 percent decline of levies would have been more than compensated by the observed increase of the EC nominal assistance coefficients between 1986 and 1990. However, it may be added that the reduction of levies gives to the PIT countries a guarantee of preference *vis-à-vis* other exporters to the EC—if not *vis-à-vis* EC producers.

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[15] Nominal assistance coefficients (NAC) are defined as follows (OECD, 1991):

$$NAC = (RBP + PSEu)/PSEu$$

where RBP are the reference border prices in national currency and PSEu the unit price subsidy equivalents which mirror the following measures: market price supports, levies on output, direct payments, other support and feed adjustment.

In sum, small increases of the quotas/ceilings combined with merely possible decreases of the levies are unlikely to have any impact on EC markets. However, they are likely to represent transfers from the EC budget to PIT farmers—raising the question whether the Association Agreements in agriculture have opened the door to a genuine trade liberalization or to an extension of the CAP to the PIT countries, and giving a first illustration of a potential drift of the Agreements towards managed trade.

Section 3. EC tariffs and NTBs in manufacturing

The section presents an overview of the situation in terms of tariffs and it shows that the EC tariff liberalization during the transition period is slower, less automatic and more selective that it looks at a first glance. Then, it examines the non-tariff barriers in the three major industrial sectors for PIT exports: textiles and apparel, steel, and chemicals.[16] The section focuses on trade barriers concerning the whole EC and all the PIT countries, and it leaves aside bilateral trade barriers between certain EC Member States and PIT countries which can be a source of trade conflicts, as best illustrated by coal where the opening of two major EC markets—Germany and Spain—to Polish exports is not scheduled before 1996.

3.1. EC tariffs on industrial products

Table 4 allows to compare the pre- and post-Association Agreement tariffs. The first four left columns provide the MFN tariffs and the average tariffs emerging from the combined enforcement of MFN and GSP schemes by industry before the Association Agreements.[17] The other columns give the information necessary for assessing a few major effects of the Association Agreements in terms of tariffs. Table 4 gives four important results.

First, the Association Agreements deliver for a second time many zero tariffs previously granted under the EC GSP scheme—though they deliver them for ever. This situation is caused by the fact that tariff cuts scheduled by the Agreements are

[16] For details on the topics examined in this *Section 3*, see Messerlin (1992).

[17] *Table 2* deserves four observations. Industries are classified according to the International Standard Industrial Classification (ISIC) at the three digit-level. Average tariffs are not weighted by imports, in order to focus on potential (i.e., in case of industrial diversification) barriers faced by CEEC exports. Combined MFN-GSP tariffs (GSP rates are GSP #1 rates) are obtained by picking up GSP rates when they exist and by taking MFN rates for the products for which there is no GSP rate mentionned. Tariffs are not always available under the form of *ad valorem* rates, mainly for agricultural products.

based on MFN applied rates. This situation occurs for a vast majority of industrial goods (80 percent of the 7,500 industrial items) as well as all PIT exports to the former GDR which faced zero tariffs until December 1991 (for limited quantities).

Second, certain tariff cuts are granted according to a timetable. At a first glance, the coverage of this delayed tariff liberalization looks negligeable. *Table 4* shows that it concerns roughly 10 percent of the industrial items. However, a more detailed examination suggests that these delayed tariff cuts—once *weighted* by PIT potential exports—are likely to give a less favorable picture of the EC tariff cuts. As shown by *Table 4*, delayed tariff cuts are concentrated in a few industries, and they concern tariffs which—on average—are initially higher than all the tariffs on industrial goods.[18]

Third, the EC MFN pre-Association tariffs on the major PIT exports such as food products, textiles and apparel are high. In other words, the scheduled decreases of tariffs in these sectors (shown in *Table 1*) imply that tariff barriers will still be substantial during the next three to five years. For instance, many EC tariffs on PIT exports of apparel will still be higher than 5 percent until 1996.

Fourth, tariff reductions granted by the Association Agreements and tariffs concessions previously under the GSP scheme are in collision course. During the first years of the enforcement of the Agreements, certain tariffs under the Agreements will be higher than they were under the GSP scheme—again because tariff cuts scheduled by the Agreements are based on MFN applied rates. Poor data on GSP benefits do not allow to provide a precise magnitude of these cases. The EC has a complex GSP scheme which grants GSP zero tariff rates for most of the goods, but under strict conditions of quantities and origin. These conditions have limited the value of tariff cuts granted under the EC GSP scheme, in particular for the major PIT exports. Assessing the value of the concessions of under EC GSP would require the detailed knowledge of the magnitude of effective PIT exports which have met all GSP constraints. Aggregated data from the EC Commission suggest that tariff quotas or tariff ceilings and rules of origin have reduced by almost two-third the benefits from GSP rates to the PIT exporters (Sapir and Presa, 1991). Based on this information, *Table 4* provides estimates of the EC combined MFN-GSP rates. If accurate, these estimates mean that PIT exporters will face until 1995 "reduced" MFN tariffs under the Association Agreements which will still be higher than the GSP tariffs they faced in 1991–1992 under the EC GSP scheme.

In sum, the EC tariff liberalization during the transition period is slower, less automatic and more selective that it looks at a first glance.

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[18] Two additional factors will determine the final impact of delays in tariff cuts; the capacity of the PIT exporters to fulfill quotas or ceilings (increased at an annual rate of 15 percent); and the EC policy (during the forthcoming years) which is not bound to apply the full duties in the case of the ceilings (the most frequent mecanism).

3.2. EC quotas in textiles and apparel

Table 5:1 shows that in 1989, a large proportion of PIT exports of textiles and apparel to the EC were subject to quantitative restrictions specified in bilateral agreements within the framework of the Multi-Fibre Arrangement (hereafter MFA): trade coverage ratios range from 42 to 58 percent. The number of MFA "product categories"—the groups of products of textiles and apparel defined by the MFA—is another indicator of the protection faced by the PIT countries. In the EC case, between one third and a half of the categories covered by the MFA concern PIT exports, with a general decline of the number of categories in 1987—a sign of a less restrictive EC policy under the Fourth Application of the MFA.

The Association Agreements did not provide the final provisions for EC quotas in textiles and apparel because the Uruguay Round negotiations are not yet concluded. However, the Association Agreements specify that the period of liberalization will be half the period determined by the Uruguay Round, but that it will not be less than five years (starting January 1st, 1993). The conditionality of the Uruguay Round raises an interesting point. As evoked by Cline (1991), certain formulas tabled at the Uruguay Round could increase protection during transitory years. Moreover, the existing Uruguay Round draft proposals of liberalization are based on all the imports of textiles and apparel—whether they are currently restricted or not—making thus possible a *de facto* postponement of any liberalization until December 1999 since at this date, the phasing out required by the existing Uruguay Round draft would be 33 percent of all EC imports of textiles and apparel. In both cases, it is not clear which solution will be chosen by the EC and the PIT countries; to follow the Round provisions or to adopt specific rules?

Without waiting for the Uruguay Round, the EC has taken interim measures for increasing MFA quotas for 1992. *Table 5:2* presents the increased quotas introduced by these interim measures in order to make comparisons with the pre-Association situation. This comparison leads to three conclusions.

First, the system of quotas on imports of textiles and apparel is maintained for the PIT countries. Indeed, the quota system has been even expanded in two ways—a point rarely mentioned. In 1992, the EC MFA quota system has been extended to new categories exported by the PIT countries, as best illustrated by flax products. Moreover, since 1991, quotas on PIT exports under the EC "outward-processing traffic" rules (hereafter OPT) have been imposed on ten (Poland) to 12 (the CSFR) product categories. OPT quotas regulate PIT exports made from inputs of textiles and apparel which have been previously imported from the EC. As a result, OPT quotas are PIT exports *conditional* to decisions by EC firms. As OPT quótas are granted to EC textile and apparel *producers* (they are not available to EC retailers or independant importers, except for few exceptions), they leave to PIT producers little initiative and no market power—a feature which makes the "OPT" quotas an instrument of managed trade. *Table 5:2* shows that OPT quotas represent a large portion of the "total" quotas (the sum of the "OPT" and "import" quotas) for all the categories—and a huge proportion of the "total" quotas for the categories that the PIT countries have fulfilled between 1985 and 1989.

Second, that the system of import quotas has been maintained means that the removal of tariffs will be without any impact on the quantities exported by the PIT countries. As a result, this removal will essentially correspond to a shift from EC tariff revenues to private rents for exporters, importers or intermediaries. However, it seems unlikely that PIT exporters will benefit from these new quota rents, particularly in the "OPT" quotas.

Third, that the quota system has been maintained suggests that the future debates on trade in textiles and apparel between the EC and the PIT countries will still be dominated by utilization rates—the ratios of actual shipments to quotas for each category, in volume. Low utilization rates for a given exporter are often presented as an argument for not increasing the quotas allocated to this exporter, on the basis that quotas larger than the actual quantities imported do not constitute a "binding" NTB.

Table 5:2 provides evidence on utilization rates. Until 1989, the averages of the PIT utilization rates for all the categories range from 66–78 (Poland) to 80–97 (the CSFR) percent (depending from the sources of data and the period considered).[19] However, these averages cover a wide dispersion of the utilization rates by category (the rates serving as the basis for trade negotiations). For instance, CSFR and Hungarian exporters exhibit utilization rates higher than 90 percent for only one-fourth of all the categories subject to EC quotas, and the corresponding proportion for Poland is one-fifth.[20]

There is evidence that casts serious doubts on the robustness of low utilization rates as an argument for not increasing quotas. PIT countries have been granted either small or large shares of EC quotas, and small quotas correspond to large portions of the PIT shipments. Such a situation is likely to "mold" utilization rates. Large quota shares contain built-in incentives not to fill them in order to exploit the

[19] Complications arising from the fact that utilization rates which partly depend on changes in the quotas themselves (a transitory decline of an utilization rate may merely mirror an increase in the quota) are determined by complex MFA rules trying to keep some kind of flexibility through various mechanisms, such as "swings", "carry-forward," and "carry-over" are ignored.

[20] This is similar to what can be observed for the textile and apparel exporters of the rest of the world to the EC. Since 1987, CEEC utilization rates by category are generally declining, an evolution which deserves two qualifications. On the one hand, a similar (though less marked) decline of the utilization rates of the other exporters of apparel suggests a relation between the evolution of the utilization rates and the relaxation of the Application of the MFA after 1987 (under the Fourth Application, compared to the Third Application). On the other hand, the relative decline of CEEC utilization rates (compared to the utilization rates of the other exporters of textiles and apparel) is more marked for the categories when CEEC prices have increased with respect to the prices of their competitors, an evolution which may mirror changes in CEEC competitiveness and/or changes in market behavior of CEEC firms.

monopolistic power attached to the situation (including possible collusion with EC producers). Small quota shares are unlikely to create strong incentives to fill them either: transaction costs make their full utilization expensive, or more expensive than for large quotas. Indeed, it has been shown that the average utilization rates (for all PIT countries and product categories) are low for the product categories where the PIT countries have very small quota shares, increase for larger shares, and then decreases steadily for even larger shares (Messerlin, 1992).

As shown by *Table 5:2*, the EC has granted to the PIT countries a first round of increases of the MFA import quotas (as opposed to OPT quotas) in 1990–1991, and a second round in 1992. On average, the first increases of the EC quotas have been moderate—between 10 to 15 percent, except for Poland—whereas the second increases of import quotas have been much larger.[21] These increases lead to two questions.

First, do such large increases correspond to a *de facto* elimination of the quota system? *Table 5:2* gives an answer for the 1990 round of increases—since trade data are still only available for 1990. It clearly suggests that the utilization rates of the PIT countries have been pretty stable (even for Poland, despite the large increase for 1990)—suggesting that the PIT countries have rapidly adjusted their export capacities to the expanded EC quotas.

Second, could this procedure of increasing quota shares create problems between the EC and the PIT countries in the future? On the one hand, one could expect that larger quota shares increase the risk of lower utilization rates for the benefiting countries. On the other hand, larger quota shares are likely to reduce transaction costs for the quotas which were initially small—hence generating higher utilization rates. If these two effects do not occur simultaneously (one would expect the second effect to be slower than the first) the PIT countries could see their future negotiating position weakened by getting larger quota shares now. In sum, the "two-stage" approach taken by the Association Agreements (where there is a decision phase between two periods of automatic liberalization) could generate the risk of creating a "stop-and-go" phenomenon which would unduly stop the liberalization process.

3.3. EC NTBs in iron and steel

In contrast to textiles and apparel, EC tariffs on steel products are modest—roughly 4 to 6 percent (as in many OECD countries) and since 1977, the bulk

[21] These averages cover wide differences in the dispersion of the quota increases by categories, as best illustrated by the different variances (241 for the CSFR, 6398 for Hungary, and 875 for Poland). The dispersions for the second increases in EC quotas are 21221, 4004, and 2895, respectively).

of protection of the EC steel industry against PIT steel exports is provided by NTBs—namely a quota system for the whole Community with bilateral quotas for five EC Member States (Germany, Italy, Belgium, Netherlands and Luxembourg). The late 1980s have witnessed the introduction of minimum price requirements and complex pricing rules, in addition to the quota system. Minimum prices and price differentials are an integral part of the "arrangements" between the EC and the PIT countries which constitute the framework of the annual steel "export programs" imposed by the EC to the PIT countries. Signing these arrangements has protected the PIT countries from potential antidumping actions by the EC steel industry.

Table 6 shows that all the PIT exports to the EC are subject to the EC NTBs. Moreover, protection by NTBs tends to be concentrated on steel products which have been granted the highest tariffs, and on the most sophisticated products (alloy iron and steel), making it difficult for PIT exporters to upgrade the type and quality of their exported steel products.

In 1991, the utilization rates for the whole EC (and for the largest market, Germany) are close to or higher than 100 percent for the EC as a whole and for the five most protected EC Member States—despite the increases of the EC quotas, in particular the large German increase related to the unification with Eastern Germany. Moreover, these high utilization rates have occurred despite the declines of the prices charged by the EC firms (quite substantial after the 1988 peaks). In other words, the protection which existed in early 1992 is likely to represent binding constraints (at constant EC market prices).

This result casts strong doubts about the real meaning of the removal of all the quotas announced by the Association Agreements. If it were enforced without other measures, such a removal is likely to create sharp price decreases in 1992—if one takes into account the slump in the EC markets and the huge excess capacities in the PIT countries (and the more modest excess capacities in the EC, at the current prices). The absence of sharp steel price movements since March 1992 suggests that trade barriers are still in place.

These trade barriers left by the Association Agreements are likely to be price provisions which—in many ways—are related to the price provisions imposed by the "basic point" system introduced by the Treaty of Paris and closely monitored by the EC Member States. That the Association Agreements did not explicitely mention the removal of price provisions and that they give three years to the public authorities before beginning to enforce the EC competition rules (without explaning the reasons for such a delay) supports the hypothesis of a trade "liberalization" which could merely consist in shifting from quantitative NTBs (maximum export quotas) to price NTBs (minimum import prices).

3.4. EC NTBs in chemicals

The main trade policy instruments affecting PIT (and the other CEECs) exports of chemicals have been antidumping regulations. Actions against the CEECs have been brought under special procedures for non-market economies (based on Article VI of the GATT and on the "code" adopted during the Tokyo Round). These procedures allow the deliberating authority to disregard the prices actually charged in the CEEC market in determining the existence of dumping (or of subsidy). Rather, the decisive factor is a reference price constructed on the basis of the costs of a "surrogate" firm in a market economy and using a technology as close as possible to the CEEC technology for producing the "like-product" in question. This approach which has proved difficult to implement has a logical consequence: assessing on the basis of past antidumping cases whether state-trading countries have dumped or not is impossible for the mere reason that the antidumping procedures have never looked at the concerned firms and economies *per se*.

Table 7 presents the antidumping cases against the chemical exports of the PIT (and other CEEC) countries. It suggests that the CEEC share of the antidumping actions is much larger—two to four times—than the CEEC share of the EC industrial imports. The 105 cases initiated by the EC Commission during the period represent roughly 25 percent of all the EC antidumping actions, whereas during the same period, CEEC exports to the EC represent only 7 percent of the extra-EC imports.[22] The chemical industry has been responsible for almost half of the cases, a situation related to the so-called "excess capacity" of the EC chemical industry during the late 1970s and early 1980s.

A large majority of cases has been terminated by measures of protection—71 percent vs 67 percent for the antidumping cases initiated against market economies—and a vast majority of these cases under protectionist measures—roughly 82 percent—has ended with undertakings (price or quantity targets accepted by foreign exporters "in lieu" of duties), the corresponding figure for exporters of market economies being 53 percent. Lastly, some EC industries exhibit very high restrictiveness ratios: 100 percent of the initiated cases in glass and almost 82 percent in basic chemicals are terminated by protectionist measures.[23]

An important aspect of the EC antidumping regime consists in the "reviews," that is, in the possibility to reopen a case during the time-span of the measures and the obligation to re-examine a case after five years (the "sunset" clause). Reviews reveal even a stronger bias against exports from CEECs than initial cases (35

[22]This result may seem closely related to the fact that the EC cases against CEEC exports have been concentrated at the beginning of the period. However, since 1985, antidumping actions against CEECs have still represented 15 percent of all the EC antidumping cases, twice the import share of the CEECs in the EC trade.

[23]*Schuknecht* (1991) provides similar results.

percent of the total number of reviews initiated since 1980) so that the decline in initial cases observed since 1985 has been largely counterbalanced by the evolution in terms of reviews. The concentration of reviews by industry is higher than the concentration of initial cases: a handful of EC industries lodges the reviews. And, in terms of outcomes, the restrictiveness ratios approach the "perfect hit" (from the EC industries point of view), though missing information on a substantial number of reviews than on cases should impose caution.

Counting initial antidumping actions and reviews does not provide a good measure of the magnitude of the EC protection against CEEC exports. It is desirable to estimate the CEEC trade shares covered by EC antidumping cases. As such a trade share indicator suffers from obvious limits, it is useful to compute a lower and a higher bound. The trade share covered by the antidumping cases initiated between 1980 and 1987 (and based on the import flows observed during the initiation year) can be interpreted as the lower bound. Each year, roughly 2 to 3 percent of additional CEEC industrial exports to the EC have been subject to antidumping actions, the former Soviet Union being—by far—the most hurt by antidumping actions, and Bulgaria the least. Taking into account all the imports under all the antidumping actions for a given year could be considered as providing a higher bound of estimates. Roughly 12 to 17 percent of the PIT industrial exports to the EC were subject to antidumping cases in 1987 according to this second measure.[24]

Lastly, the high *ad valorem* equivalents of the EC antidumping measures—estimated on average to almost 20 percent, as shown by *Table 7*—have left the CEEC exporters with no other reactions than to curb their exports to the EC—on average by 20 percent five years after the case initiations.[25]

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[24] This higher bound is still likely to underestimate the trade coverage of antidumping actions. For instance, the EC-CEEC trade in steel is still included in the denominator, though the "arrangements" have led to its *de facto* elimination from the scope of the EC antidumping actions. However, the most important source of bias is that antidumping actions are likely to curb imports. A simple way to take into account this fact is the cumulation over the years of the trade shares observed in the new cases—hence assuming that these shares would not have changed if the antidumping cases would not have been initiated and if trade was going as usual.

[25] The average *ad valorem* equivalent of the antidumping measures is the unweighted average of the *ad valorem* antidumping duties, the margins of dumping (for undertakings terminated on the basis that measures taken by the firms will eliminate the dumping) and the margins of injury or the observed price undercuttings (for undertakings terminated on the basis that measures taken by the firms will eliminate the injury).

Section 4. Rule-making: a constitutional failure?

The Association Agreements intend to support the transition of the PIT countries to a market economy. However, they contain certain aspects which are likely to undermine this objective, in particular, several instruments of managed trade, a rich collection of safeguard rules, a complex protocol on rules of origin, and a dispute settlement mechanism which is dominated by administrative procedures, not immune to non-transparency, and with no direct access for private firms or consumers.

All these aspect are in sharp contrast to the robust constitutional order imposed by the Treaty of Rome, including the dispute settlement mechanism—the European Court of Justice has been the most crucial force in making competition the ultimate goal in the EC.

4.1. A potential drift to managed trade

The above sections have already shown that remaining trade barriers—such as the capture of the reduced variable agricultural levies by EC and PIT farmers, and the introduction of large OPT quotas in textiles and apparel in favor of EC firms—have a strong bias towards managed trade.

Another source of managed trade is provided by the annex of the Association Agreements devoted to trade in automobiles. Because former state-trading countries have been plagued by export controls (as binding as import controls) the Agreements contain provisions imposing the elimination of restrictions (taxes and quotas) on exports. However, this elimination has generated precedents of "voluntary import expansion" schemes in favor of the EC car industry. The best illustration is given by the Hungarian ceiling of 50,000 passenger cars originating from the EC (and Hungary has agreed to review this quantity by taking into account changes of its internal consumption). Although the EC-Poland Agreement contains only duty-free quotas, the Polish government wanted to grant this preference only to EC carmakers having invested in Poland—hence again establishing a link between PIT domestic variables and EC exports (The Financial Times, 26 and 27 February 1992).

As often in such cases, elements of managed trade quickly contaminate other trade flows. Recently, Japan has requested information in the GATT forum on the future Hungarian tariff system which would create highly discriminatory duties between the EC and the rest of the world (respectively, 0 et 35 percent).

4.2. Safeguard provisions

The Agreements contain eight safeguard clauses. There are two "general" safeguards. Article 6:3 makes the jump to the second period of five years created by the Agreement conditional to a decision of the Association Council—a clause quite comparable to a provision of the Treaty of Rome. Another safeguard provision which is relatively general—though specific to trade in goods—is provided by Article 30 which is likely to play the central rőle, as shown in detail below.

In addition to these two "general" safeguards, there are six safeguards specific to some goods or types of activities or countries. Article 21 is a special safeguard provision for agricultural goods—"given the particular sensitivity of the agricultural markets." Meat (in the Annex X) and the processed agricultural products (in the Protocol 3) have also special safeguard provisions. The final Protocol on textiles and apparel is likely to have its own safeguard clause. Article 31 introduces a safeguard measure on exports aimed at limiting exports if necessary—an echo of the former CMEA rules where protection cover exports as well as imports. Lastly, Article 28 grants to the PIT countries the possibility to take "exceptional measures" of limited duration when "infant industries" are concerned or when "restructuring or facing serious difficulties, particularly where these difficulties produce important social problems."

From the EC perspective, the central safeguard provision which is likely to supersede the other provisions is provided by Article 30.

It is useful to compare Article 30 with the safeguard provision of the Cooperation Agreements which was considered dangerous for four reasons. It made no reference to the basic concept of "unforeseen developments" of GATT Article XIX. The condition of "increased quantities *and* conditions causing serious injury" usually associated to the safeguard clause was considerably weakened by a shift from "and" to "or." The measures available to the importing country explicitly refered to quantitative restrictions and minimum prices, another shift away from GATT disciplines. Last but not least, the actions were conceived in a purely bilateral context—making very likely a "selective" use of the safeguard provision.[26] Article 30 has inherited all but one of these biases: it contains no reference to unforeseen developments, all measures are possible under the enigmatic condition that "priority must be given to those which least disturb the functioning of the Agreement", and these measures are bilateral—hence selective. Moreover, the only improvement in Article 30—the elimination of the "or"—is more than counterbalanced by the introduction of the following alternative condition to the usual condition of serious injury for triggering safeguard: "...or serious disturbances in any sector of the economy or difficulties which could bring about serious deterioration in the economic

[26] These drifts which "understandably" existed in the Cooperation Agreement signed in 1988 with Hungary have been maintained in the more recent agreements.

situation of a region." This condition represents a major drift, exacerbated by the fact that Article 30 refers to the procedure stated by Article 33—that is, an administrative, bilateral, and non-transparent procedure.[27] In fact, Article 30 reminds the way conflicts concerning the steel trade between the EC and the CEECs have been handled under the "arrangements" described above.

If the above reading of Article 30 is correct, antidumping provisions (Article 29) are likely to be superseded by Article 30 provisions (for a somewhat different approach, see *Hindley* 1992). In this respect, it is interesting to note that the Agreements do not grant the status of a "market economy" to the PIT countries. Article 1 mentions that an *objective* of the Association is "to support the *conversion* (of the PIT economy) into a market economy" (author's emphasis). As a result, the Agreements leave open the question of whether antidumping procedures to be enforced in future cases of alleged dumping by PIT firms will be the procedures against non-market economies or against market economies. In any case, conditions imposed on antidumping procedures are likely to be more constraining and costly than a direct access to Article 30—even if procedures against non-market economies are applied. As a result, one would expect antidumping actions only for well-defined homogeneous goods—and essentially as a highly visible signal of commitment by the EC industries to defend their existing turfs.[28]

In sum, the safeguard provisions of the Agreements are powerful enough to reverse the trade liberalization aspect of the Agreements—and to set undesirable precedents for the GATT disciplines. The first years of enforcement of the Agreements will tell whether the safeguards play such a rőle. For instance, the steel industries of the EC and PIT countries have so many excess capacities of production that an effective liberalization should lead to severe price drops. It is thus likely that stable prices in the years to come will be the sign that Article 30 has been powerful enough to convey the message to the PIT producers that they should follow collusive pricing.

One could argue that this view does not fit with the provisions on competition, such as Chapter 3 of the Protocol on coal and steel products which declares incompatible with the proper functioning of the Agreements "all agreements of co-operative (...) nature between undertakings which have as their object or effect the prevention, restriction or distortion of competition." However, the Association Councils have three years for adopting the necessary rules for implementing this

[27] Two conditions are imposed on the measures. In the selection of the measures, priority must be given to those which least disturb the *functioning* of the Agreement (not the economic impact). In terms of timing, measures shall be subject to periodic consultations, "particularly with a view to establishing a timetable for their abolition as soon as circumstances permit."

[28] Such a conclusion seems to fit existing evidence. A few days before the signature of the Association Agreements, there have been three antidumping complaints against PIT exports lodged by EC firms (steel tubes from CSFR, Hungary, Poland, in December 1991) and none since then (complaints against the USSR-CIS and other CEECs have been lodged).

provision. As a result, competition cases in steel involving the PIT countries could only emerge in the short run from disputes between two EC firms which would indirectly imply PIT firms.

4.3. Trade-related restrictions: rules of origin and foreign direct investments

Given the small size of the PIT economies, foreign direct investment (hereafter FDI) in the traded goods sector is unlikely to occur on the basis of domestic market opportunities alone. Rather, OECD firms are most likely to be willing to invest in export-oriented activities, as already illustrated by major investments in the PIT automobile or electrical industries. Whether this will continue and expand will crucially depend on the trading environment.[29] Two measures will be especially important in this respect: rules of origin and norms and standards.

Rules of origin are of special importance for the PIT countries for two reasons.[30] Since the PIT countries have relatively abundant supplies of labour, they may be attractive sites for both the production of labour-intensive parts and for the final assembly of products. The PIT countries lack the technical and managerial skills to produce complex products in a fully vertically integrated way. Thus, future production will depend on international flows of parts and services, especially within the production systems of multinational corporations.

The Protocol on rules of origin attached to the Agreements provides two sets of definitions of rules of origin. First, products originating in a PIT country are those wholly obtained in this country. This initial definition is accompanied by a list of products which shall be considered as wholly obtained and which mainly are mineral and agricultural products. An interesting example of the complexity of these rules is that fishes are considered as wholly obtained in a country only if they are taken by national vessels (opening a long list of constraints on ownership and nationality of the members of the boards of the firms and of the crew).

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[29] "There is no way in which rational investment can be reached within individual eastern European countries unless they know where they can export to and on what conditions. How can these small and open economies take their place in the international division of labour unless they are able to specialize in fields in which they enjoy a comparative advantage? And how can Western corporations be encouraged to invest in countries whose internal markets are far too small to warrant any sizable investment, unless they see their investment as part of their own international deployment of production facilities?" (Bank of International Settlements, 1991).

[30] Rules of origin define the origin country for goods and services which incorporate elements or components produced in a number of countries. These rules serve to determine the conditions—tariffs, NTBs and other trade measures—under which these composite goods and services may be imported. As economic integration proceeds at the world level, firms have increasingly sub-divided the production of goods between plants located in different countries in order to reap economies of scale at each site while exploiting the comparative advantage of each site.

Second, products originating in a PIT country can be those "obtained" in the PIT country in the manufacture of which products (not wholly obtained in the country and not obtained in the EC) are used, provided that the said products have undergone "sufficient working or processing." For most of the products, the definition of these terms is subject to a strict clause of change in custom headings: a product is sufficiently worked or processed when it is classified in a heading (at the *four*-digit level) of the Harmonized System which is different from that in which *all* the non-originating materials are classified). However, for the rest of industrial products (for instance, those subject to the Annex II in the EC-CSFR Agreement) the rules of origin obey to a threshold expressed in terms of production of the PIT country: inputs imported from non-EC sources should not represent more than 40 or 50 percent of the value of the production. In sum, the Association Agreements (which devote 45 pages—that is, between one fifth and one fourth of the whole documents—for describing these "exceptions") impose a local content requirement of 60 percent.

To summarize, the rules of origin applied to the PIT countries represent a serious constraint. Assembly plants in the PIT countries other than based on bilateral trade between the EC and the PIT country are *de facto* excluded from the scope of the Agreements.[31] The harm done to the PIT countries by these restrictive rules of origin will also hurt the EC because EC firms will not be able to invest in as well located (and maybe many) plants as would be optimal from an economic point of view, and because they would be forced to bear additional costs related to inefficient part-makers.

Related to rules of origin are norms and standards which generate marketwide agreements (mandatory in the case of norms, voluntary in the case of standards) on technical requirements for traded goods and services.[32] However, in the short and medium run, norms and standards are less likely to play a rőle in hindering access by PIT producers to OECD markets than rules of origin. The concentration of PIT exports on the EC and EFTA markets suggests that adopting EC norms and standards (through "mutual recognition") is the sensible policy for the PIT countries—an approach which will be facilitated by (and which will facilitate) investments from the EC and EFTA countries. It is only in a longer run that norms

[31] The only degree of freedom is a certain degree of "cumulation" of origin between the three PIT countries. For instance, a product exported from Hungary to Poland having undergone no working or processing in Poland or insufficient working or processing to be considered as originating in Poland will continue to keep its Hungarian origin for the EC customs.

[32] Norms and standards are important in industries where consumer protection is an important policy concern—food manufacturing, electrical goods, and services—and in those subject to rapid technological change—consumer electronics. They may concern the goods *per se* or the production techniques. In both cases, they can restrict trade without the intent to do so, or they can be used as NTBs. There is evidence which does not allow to rule out their use as NTBs, though it cannot give any clue on the intent.

and standards could endanger PIT exporters, if they are used as NTBs *between* OECD countries.

Conclusion: Why such a soft EC support?

The ambiguity of the Association Agreements reveals the absence of an EC strong support to the trade liberalization of the PIT countries. Why such a soft EC support?

One could explain this "softness" by a historical argument: the Association Agreements are based on two different motives. On the one hand, they reflect the EC reaction to the trade liberalization undertaken by the PIT countries, and in this respect, they obey the motive of freer trade. On the other hand, the Agreements materialize the EC commitment consistent with the Single Market Programme—thus, taken *before* the events in Eastern Europe—to unify for 1993 the trade policies of the EC Member States *vis-à-vis* the CEECs.[33] This commitment was primarily based on a logic of harmonization which could lead to two opposite outcomes in terms of liberalization: quotas enforced by EC Member States could be removed *or* they could be replaced by EC-wide quotas. In other words, the Association Agreements may have aimed at unifying the EC trade policy vis-à-vis the PIT countries more than at opening EC markets to PIT exports.

This historical argument may shed some light on the difficult position of the Commission which was more free trade oriented than EC Member States but which was also more interested in unifying the EC trade regime with the PIT countries because a common regime means more powers to the Commission. However, the historical argument leaves intact the question: why the liberalization motive did not prevail?

A first answer could be the economic costs of a strong support for the EC countries. As well shown by *Blackhurst* (1991), this answer is not plausible at the level of entire economies. The relative size of the economies is well illustrated by the fact that the PIT countries altogether—according to the GDP estimates provided by *Keating and Hoffman* (1990)—represent a GDP roughly equivalent to the Austrian GDP alone.

[33] In the late 1980s, the EC Member States were still running their trade policies vis-à-vis state-trading countries in quite an independent fashion which was enshrined in EC Regulation 3420/83 (for more details, see *Nello* 1990). This situation was the consequence of two facts: the state-trading countries never took part of the exercises of quota elimination (within the GATT and OECE-OECD framework) and that political situation did not induce the EC Member States to unilaterally drop their protection. According to *Langhammer* (1990) many of these national quotas were not strongly enforced. The EC-Hungary Cooperation Agreement signed in 1988 was the first illustration of this commitment—and it was the blueprint of all the Cooperation Agreements.

A second answer is to look at costs by sectors. Small costs for the entire EC economy may be concentrated on a few sectors which will be import-competing—and make them lobbying hard against a strong support. Rough estimates of the *maximum* costs of a full (tariffs and NTBs) EC total and unilateral liberalization (that is, much more than the Association Agreements) on the four EC sectors which will compete with the PIT exporters (agriculture, steel, textiles and chemicals) suggest maximum decreases of sectoral outputs from 2 to 4 percent, at most (and only in agriculture and apparel).[34] The low costs explain why the negotiations of the Association Agreements have not been accompanied by large demonstrations against the PIT countries—except in agriculture (France) and steel (Germany), that is, in a context where trade issues with the PIT countries were an additional friction rather than the central issue.

The last answer could only come from the *EC export side*. If the activities of the import lobbies have been relatively moderate, the weakness of the EC support can only be explained by the absence of EC export lobbies. Indeed, comparing the negotiations of the Association Agreements and of the US-Mexico FTA shows no exporters' coalitions in the EC similar to what can be observed in the U.S. Three reasons—all of them related to exporters—can be evoked.[35]

First, the small size of the PIT markets in the near future (compounded by the difficulties of the transition) may have left potential exporters with (properly discounted and risk-adjusted) low profits. The PIT economies are simply too small and too uncertain to make the EC rich. Over time, adequate PIT policies can change this attitude.

Second—and this reason is more worrisome because it is there for a long time—certain rules of the Association Agreements are likely to have definitively lowered the expectations of EC exporters—such as the clause of the "infant industry" at the disposal of the PIT countries—or to have definitively lowered the expectations of EC investors—such as the provision introducing EC technical assistance for the introduction of social security in the PIT countries.

Lastly, certain rules of the Association Agreements have offered better alternatives to some EC exporters than to use these trade negotiations for their own interests, as best illustrated by the car case. Why should the EC carmakers—one of the EC sectors with the potentially largest export interests in the PIT countries in the short run—bother to push for opening up EC textiles or steel markets, once their market access to the PIT countries is secured in terms of domestic consumption of these countries?

Trade agreements do matter, as shown by Section 1. If the Association Agreements did not grant to the PIT countries more EC trade concessions than the

[34] For details, see Aghion, Burgess, Fitoussi and Messerlin (1992).

[35] *Krueger* (1990) has revealed and analyzed the importance of the asymmetries in policy between exports and import-competing goods.

previous EC-PIT trade agreements—as suggested by Sections 2 and 3—and if the additional EC concessions are undermined by loose rules—as shown by Section 4—then the economic problems faced by the PIT countries will not be relieved by additional exports to the EC—as they were in 1990 and 1991—and the EC will have lost an unique opportunity to be a strong anchor in Europe.

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THE POLITICAL ECONOMY OF STATE-BUSINESS RELATIONS IN TAIWAN[1]

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The economic development of Taiwan had been characterized by low efficiency of the party-state sector and by serious failures in the economic policy of the state. Small business and its cooperation with the world economy have become the real sources of Taiwan's success story.

Introduction: East Asian development reexamined

Towards the end of the 1980s, the study of East Asian development moved beyond the paradigmatic debate between modernization theory and dependence/world system perspectives and began to look closely at those important contexts and agents that have contributed to the making of East Asian success, and also started to examine consequential development issues. Though the original theoretical formulations were consciously retained, empirical explanations were more carefully clarified and critically assessed in the context of East Asian reality (*Hsiao* 1992a). The specificity of individual society within the general framework of the East Asian NIEs (Newly Industrialized Economies) is now being given greater attention with regard to the way in which the broader global economic contexts interplayed with the domestic actors, such as state politics, the business sector, labour and other socio-cultural fabrics during the course of post-war development (*Hsiao et al.* 1989a; *Amsden* 1989; *Wade* 1990). Lessons, cautions, and warnings are also being drawn from the East Asian experience and applied to the rest of the developing world (*Winckler and Greenhalgh* 1988; *Deyo* 1989; *Bello and Rosenfeld* 1989; *Gereffi and Wyman* 1990; Wade 1990). Much more concrete analysis of the transition of the authoritarian state, the class transformation, the emergence of the middle classes, and the rise of social movements has been added to the research agenda, and some very interesting works have appeared recently (*Cheng and Haggrad* 1992; Hsiao 1991; 1992b; 1992c).

It is an encouraging direction for scholarship to go beyond the general portrait of what East Asia has accomplished, or praise of the East Asian model in order that it available uncritical emulation; research is now carrying out a more penetrating examination of what actually has been going on within and beneath the East Asian development drama as it has unfolded.

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In the 1980s, three major approaches emerged in literature dealing with East Asian development studies. Each of the three approaches centred its focus on one context or agent believed to have played a critical role in the development process of East Asia.

The first is the global political economy approach. This takes the world economy as the crucial external context which has incorporated East Asia into the global market and provided new opportunity structures of which East Asia has been able to take advantage. It is a sort of revised world system explanation, in that the dependency of a peripheral state on the core state within the world economy is not necessarily doomed to be underdeveloped. Rather the dependency can be managed so that it is beneficial to the ascent of a peripheral state or a peripheral region.

The second approach takes the state seriously in its role of steering and guiding state development strategies and policies such that they can meet the challenge from the global political economic system. The state is viewed as active and interventionist in both external and internal economic activities. The following issues have been given much attention among scholars using this approach: the question of the relative autonomy of the state *vis-à-vis* the dominant local class when starting out on national development policies is the most discussed topic; the relationship between the state and market forces, and the question of whether the state has been the leader or been led in such relations are also much stressed. Finally, the debate concerning whether or not authoritarianism is a necessary evil for development in the case of East Asian NIEs is another unresolved issue that has occupied many scholars working along this line of analysis.

Compared with the previous two, the third approach is a rather new focus of East Asian development studies. The two former approaches have respectively asserted that 1. the unique world political economy in which East Asia was integrated in the post-war era has been conducive to the capitalist development in this region, and 2. the unique nature of the state in East Asia and the development strategies adopted all have been functional in the initiation and maintenance of successful development. However, the third approach calls our attention to another important agent of capitalist development—ie. the business sector, and the role it has played in the course of East Asian development.

It is quite convincing to argue for a new look at the business sector if the picture of East Asian development is to be complete in that this sector is the central actor in any capitalist development. It is known that favourable timing and external linkages with the global political economic contexts, and the fact that active developmental states responded positively and forcefully to the world system have been fundamental to the success story of East Asia. Yet the story is not complete if the business sector is not examined. The essence of this business approach lies in its emphasis on how the business sector responded to the state development initiatives and the world market opportunities at the beginning and then, later, reshaped the course of capitalist development in East Asia.

The purpose of this paper is to use this new approach to reexamine Taiwan's post-war economic development experience. As suggested by this general analytical framework, three interrelated themes are to be explored here.

First, the relations between the state and business, and the political economic contexts in which state forces have interacted with the different sectors of business in Taiwan.

Second, the mechanism that has been employed by the state to strengthen links with business, and the business response to these relations; and within this the way in which the two actors' interactions have been institutionalized and stabilized in the course of Taiwan's capitalist development.

Third, the change and transformation of state-business relations and the socio-political forces behind the changes, and the future prospects and implications for Taiwan's further socio-political development.

The political economy of the state and private capital in Taiwan

For a long time now, Taiwan's political economic structure has been characterized by a strong and authoritarian, yet developmental, state, a mass of politically weak, yet economically dynamic, small and medium business, and alongside these an ever growing powerful big business sector. This structure has been quite stable since the years when Taiwan began its export-oriented industrialization (EOI) in the 1960s.

The nature of Taiwan's Kuomintang (KMT) authoritarian developmental state has been established in different phases. The authoritarian corporatist rule of the KMT state was already firmly rooted in Taiwan even before the state-led rapid industrialization that took shape in the 1960s. The export-oriented industrial development further-perpetuated the political authoritarianism over all aspects of civil society, including the business sector. In other words, unlike in Latin America, Taiwan's bureaucratic authoritarianism was not deliberately established in order to enact state-led export promotion strategies, for it was a pre-existing structure. The dynamic and impressive industrial growth has had the effect of legitimizing the state's powerful authoritarian rule, especially since the export-oriented industrial development phase.

On the other hand, the business sector as a whole was first nurtured and boosted in the (post-land reform) import substitution industrialization phase (ISI) and it has been more or less subjected to the state's corporatist control since the 1950s. The first generation of landlords-turned-capitalists was created in the 1950s and the first generation of export businessmen appeared in the 1960s. By the 1970s, the big capitalists that dominated the domestic market, and a great many small and medium entrepreneurs who were concentrating on the foreign markets, constituted Taiwan's business sector.

It is not exaggerating to say that both the big capitalists and the small and medium businessmen were in fact the products of the state's leadership. It was the latter which implemented the consequential industrialization strategies in response to both internal and external political economic challenges. The land reform policy that produced the first generation of indigenous capitalists in Taiwan was forcefully implemented by the KMT regime from the Mainland to ensure its political control over the then agrarian Taiwan society. The first ISI strategy in the 1950s was adopted primarily to meet the domestic economic needs and to build local industrial capabilities. The main beneficiaries of such a strategy were the dominant state-owned enterprises, the industries owned by people on the Mainland, the emerging Taiwanese landlords-turned-capitalists, and a few local entrepreneurs who made a quick response to the state's industrial initiatives.

The export-oriented industrialization (EOI) strategies that followed the first ISI phase then fostered an even larger number of local business establishments. It witnessed a significant rise in Taiwanese small and medium export-directed enterprises. These existed side by side with the increasingly large business sector controlled by both Mainlanders and Taiwanese. The latter had originated in the previous ISI phase. The strategic shift from ISI to EOI, though not necessarily a clear cut one, was induced and pressed by both domestic market constraints, external US pressures, and then the foreseen expansion of the world market's concentration on the west. The global market provided new opportunities and the state responded in a way that turned out to be favourable to Taiwan's later development course. Namely, the result was the emergence of a large number of dynamic—yet small—export manufacturers. It is important to note that under ISI protectionist policy and the state's political manoeuvre with business, the existing big business already enjoyed an oligopolistic position in the domestic market. Therefore, big business was not interested in expanding its activities to the uncontrollable and non-protected foreign markets. The rising small and medium business thus had the chance to fulfil the "call" from the state's EOI initiatives.

The resulting large quantity of small and medium businesses aiming at the world market should not be interpreted as a conscious and intended policy that had been planned by the state. Rather it reflected the unequal division of labour in the unique political economy of Taiwan that was dominated by the KMT state and its protected big business and the state-owned enterprises in the domestic market. In other words, the newly emerging export market, with high competition and without the state's direct sponsorship, was then left in the hands of those originally constrained small and medium businessmen who now saw the world market as the only channel to make gains and to move upward. The "dichotomous or dual market structure" has thus been rooted in Taiwan's political economy since the late 1960s (*Chou* 1989).

An other important external contextual factor that unintentionally produced this dual market (business) structure came from the core states, particularly the US. In the immediate post-war years, Third World countries and East Asia alike sought rapid industrialization using ISI strategies that aimed to spawn local industries which would manufacture local substitutes for imports, while the US saw its interests being best served by global free trade. The US firms and US capitalists could use their efficiency to drive out the competition in unprotected markets. With the aim of undermining the ISI model, the USAID, the World Bank began to formulate the strategy of EOI. This encouraged the Third World to employ its reserves of plentiful and cheap labour to produce low-tech manufactures such as textiles, garments and shoes, for export to advanced country markets where their low labour costs would give them a competitive advantage (*Bello* 1991). A series of policy recommendations were therefore urged by the World Bank and the US. Taiwan, in this connection, was under direct pressure from the US aid instrument and began the process of "structural reform" by issuing the 19 point "financial reforms" in the late 1950s and the early 1960s. Included in the package were devaluation of the New Taiwan currency to make exports more competitive, the relaxation of control over foreign trade, the admission of foreign direct investment in setting up export manufacturing enterprises, and the initiation of the singular exchange rate alongside the elimination of import restrictions. In 1960 "The State for Encouragement of Investment" was also issued in order to offer greater tax-reducing incentives to stimulate private investment and exports. Moreover, the EOI strategy of Taiwan coincided with the needs of US multinational enterprises in the 1960s: namely, the latter seized the opportunity to move their operations to Taiwan in order to utilize local cheap labour to export back the manufactured products to the US and the world markets. Such "re-export" activities of the US firms had a dual purpose: to gain a higher return rate for their investments by lowering the labour costs and to compete with Japanese imports such as televisions, micro-chips, and computer goods in the US market (Bello 1991).

Foreign direct investments in Taiwan from the US and Japan induced a wide range of supporting small and medium enterprises and these took advantage of the newly emerging export promotion policies set up by the state. More importantly, the export market was not interested in the big business. One other arrangement that even helped accelerate the small and medium firms and manufacturers was the so called "OEM" (original equipment manufacturer) employed by the US investors. With this, the local manufacturers were assigned to produce products later sold under US brand names. Taiwan has been a subcontracting centre since the 1970s, and a sophisticated institutionalized arrangement was established during those years. In fact, dynamic export performance was largely attributed to those local OEM factories and firms that constituted the main body of Taiwan's local small and medium enterprises (*Hsieh* 1989).

The dual market structure, therefore, should be understood within the above-mentioned internal and external contexts, especially the nature of state-business relations, the pressure from the World Bank, the US government and the multinational corporations.

In the early 1970s, due to withdrawal from the UN and the oil crisis, Taiwan faced a serious setback in economic performance. The drop in business confidence and the outflow of capital brought about a temporary halt to export dynamism, and the diplomatic setback even led to the KMT state's legitimacy crisis. The state then began the second ISI strategy to restructure the domestic industrial structures by developing energy-intensive and capital-intensive industries and large-scale infrastructural projects.

Under the second ISI initiatives, the state enterprises increased their significance in leading the domestic investments, while the big businesses also received even greater boost from the state and turned into "business groups", the Taiwanese version of a conglomerate. The small and medium businesses, on the other hand, survived from the world energy crisis and recession at the time and were reinvigorated for further growth and development that began in the late 1970s. Since the 1980s, Taiwan's political economic structure in relation to state and private capital has become even deeper, although it has also experienced transformations.

Without doubt, the state has exercised the dominant role in Taiwan's economy, and under the state's effective political and policy mechanisms, both big business and small and medium enterprises were created. The domination of the economy by the KMT state did not only take the form of hands-on direction and guidance to the business sector, as was the case in South Korea. Rather, in Taiwan, the state has physically owned massive segments of the economy by controlling significant numbers of state-owned and even party-owned business operations. Beside this is the fact that the state owns about 70 percent of the island's land.

The following are further portraits of the relative weights of Taiwan's three business sectors: the state/party enterprises, big business, and small and medium enterprises.

The state and party enterprises

The origin of Taiwan's state-owned enterprises can be found with the taking over of ex-Japanese Zaibatsu and Japanese colonial government after the war. Later, more new state enterprises were established. In 1952, state businesses accounted for as much as 57 percent of total industrial production, 43 percent of the domestic capital formation, and employed 17 percent of Taiwan's civilian employees. On the completion of the first ISI in 1960, public enterprises' industrial output fell behind that of private business for the first time, and the figure dropped to 48 percent, their share of the domestic capital formation was about 34 percent, and the state hired 11 percent of the employed labour force. In the mid-1970s when EOI was turning into the second ISI, the state enterprises once again received a big push from the state. Though their share of overall industrial production dropped steadily to 22 percent, they contributed a growing 43 percent of domestic capital formation, and employed 12 percent of Taiwan's total employees. In the late 1980s, the state enterprises accounted for below 20 percent of Taiwan's industrial production, their average share of domestic capital formation was about 22 percent and they hired under 10 percent of Taiwan's total workforce (*Lee* 1992).

It is true that the relative weight of state enterprises in Taiwan's economy has been declining over the past four decades, judged by the above figures. However, the state sector's involvement in the economy remained significant. The heavy penetration of the state in such strategic and key sectors as petroleum, electric power, steel, gas, railways, shipbuilding, postal services and telecommunications, tabacco and spirits, banking and other financial segments has reached a monopolistic level, and the nature of state and bureaucratic capitalism as reflected by such state dominance in those crucial sectors has therefore been examined by some experts (Amsden 1979; *Kuo* 1991; *Chen et. al.* 1991).

As late as 1990, ranked according to sales, four of the top ten businesses were state-owned, and the largest private firm, Nan-Ya Plastics was outstripped by three state enterprises (China Petroleum, Taiwan Tabacco and Wine Monopoly Bureau, and China Steel Corp). Again, among the top ten firms ranked according to assets in 1990, as many as six were state-owned (1990 Commonwealth Top 1,000 Enterprises). Moreover, the state enterprises have also diverted their investments in 40 large private businesses and 7 foreign firms in Taiwan (Lee 1992). By doing so, the state sector has in fact been able to control the direction of the private firms in which it has investments.

In addition to the direct control of the state business sector, the KMT party also owned wholly or partly around 50 companies, mostly through the two powerful and privileged party-owned investment firms. These party-owned companies ranged from communication to petrochemical industries, to steel and electronics, and even to finance and security (Excellence Magazine, 1989; Chen et al. 1991). The later development of joint ventures involving the party investment firms, the state enterprises, and the big private companies has even further empowered the party's penetration in Taiwan's private sector. What has emerged is a new kind of party-state-private capital bloc. Nevertheless, it is free from bureaucratic supervision and has enjoyed a great deal of the state's special favourable privilege through political manipulation (*Chu* 1989). According to unofficial estimates, about half of the total assets of Taiwan's corporations are controlled directly or indirectly by the state and the party (*Asian Wall Street Journal Weekly*, Oct. 9, 1989).

The big business (Business groups)

As mentioned earlier, at the end of the first ISI, several big private enterprises emerged with direct state assistance. US aid was used to advance the interests of KMT-linked Mainland businesses of Shanghai and Shantung origins and a few local Taiwanese landlords-turned entrepreneurs. With profits guaranteed by a closed market and costs subsidized, Mainland-owned enterprises were the main beneficiaries of the state's ISI initiatives. They floated to the upper level of the business power structure in the period prior to 1960. Of the top 21 Mainland-controlled business groups, 15 were established long before 1960. Even in 1981, among the top ten private business groups, three were Mainland-owned (Far Eastern, Yue Loong, and Pacific Electric Wire).

The first generation of Taiwanese landlords-turned-capitalists that forged political ties to the KMT state were other business segments that benefited directly from the state's ISI and EOI strategies in the 1950s and the 1960s. In most cases, the Taiwanese big groups were also formed in that periods under KMT patronage. Later they were joined by other Taiwanese industrialists like Formosa Plastics' Y. C. Wang, who made quick response to opportunities presented by the state's industrial priorities, which themselves were greatly assisted by the US aid in the early 1960s. The Taiwanese gradually superseded the Mainlanders to resume a dominant role in Taiwan's big private business sector. Towards the end of the 1980s, among the 97 private "business groups" (multi-company establishments) in Taiwan, 75 were Taiwanese owned, 13 were in the hands of the Mainlanders, and the remaining 9 were jointly controlled by both Taiwanese and Mainlanders (*Peng* 1989).

The KMT state has been constantly ambivalent towards the Taiwanese big business groups, and there has always been an ethnic tension-management between the Mainland state and Taiwanese business. There were fears on the part of the KMT state of the Taiwanese ambitions for self-determination and independence if they were excessively empowered both politically and economically. It was not simply speculation to say that in the second ISI phase in the 1970s, an ethnic power struggle between the state and Taiwanese economic interests was a consideration when the state enterprises were given a dominant role in leading major industrial projects. Though the rationale given by the state was that private capital did not have enough capability to make the huge investment needed to support accelerated industrial expansion in Taiwan, the unspoken reason was that the KMT wished to solve its legitimacy crisis and resume its economic domination by boosting the state-controlled sector. Behind such a move was the Mainlander state's efforts to continue to exercise strategic direction of the island's economy *vis-à-vis* the up-and-coming private capital controlled by the Taiwanese business class (Bello and Rosenfeld 1990).

An other political mechanism to keep the Taiwanese business class in check was through cooption: i.e. by recruiting many rising Taiwanese elites or their sons to run for political office. It was indeed a calculated effort in the late 1970s to cement the political links between the KMT state and the Taiwanese business class. It is highly likely that the political and economic interest will be strengthened between the state and the private capital, Mainlander and Taiwanese alike, in the 1990s. This is a sign that has been visible since the 1980s. The Taiwanese big businesses have been linked with their Mainland counterparts through joint investments and positions in the governing boards of trade associations and other business organizations (*Namazaki* 1986). The Taiwanese and Mainlander divide in the business circle will be eliminated and they will certainly merge into a powerful capitalist interest bloc.

In 1988, the top 100 business groups of Taiwan accounted for 34 percent of the total GNP, yet employed only 4.63 percent of Taiwan's employed labour force, and comprised 700–800 firms (China Credit Institute, 1990–1991). The business groups have heavily concentrated their investments and business operations in capital and technology intensive industries, and they began to enter the financial sector like banking and security after the state permitted new banks to be established in 1991. As in the 1980s when big industrial capitalists emerged in Taiwan's private business sector, a new breed of big financial capitalists will soon be formed by the mid-1990s. It is important to point out that behind these new private banks are again those powerful interests from the big industrial capitalists who finally merged their industrial capital into this newly opened financial sector. In other words, what is to be seen is a rising joint economic force of the industrial and financial capitalists that will exert even more power and influence in Taiwan's future political economic arena.

The small and medium enterprises

Outside the above powerful state-party-private capital core was the presence of a large number of small and medium entrepreneurs. In 1989 there were 773,511 registered business enterprises in Taiwan, and 97.72 percent of these were considered small and medium business, with capital under NT$ 40 million (US$ 1.5 million) and the total assets below NT$ 120 million (US$ 4.8 million). To make the picture more dramatic, 99 percent of all enterprises in manufacturing sectors like food products, garments, non-metal furnitures, and printing, etc. were in the hands of those small and medium businessmen. They provided about 71 percent of Taiwan's employment, and contributed around 46.3 percent of Taiwan's industrial production in value terms. However, they constituted only 26.11 percent of all business sales in Taiwan (*Wei* 1991). According to the Industrial and Commercial Surveys from 1966 to 1986, more than 95 percent of all manufacturing units hired less than 50 employees, 80 percent less than 20, and 70 percent under 10 (Hsieh 1989).

However, the small and medium enterprises have been the back-bone of Taiwan's trading economy, and accounted for more than 60 percent of total exports in the 1980s. Taking manufacturing exports alone, they contributed up to 65 percent of all these. In addition, more than 70 percent of Taiwan's small and medium enterprises' total business income was generated from exports.

All the above figures have characterized Taiwan's small and medium business sector very well: they are not just relatively small compared to those big business; they are in absolute terms small both in capital, sales, production, and the labour employed in individual business units. Yet, as a whole, they provide many more jobs than the big businesses, and they are the primary source of dynamism of Taiwan's export economy, the twelfth ranked trading power in the world in 1991. Moreover, the very existence of large numbers of small firms with significant capital decentralization should be appreciated as one of the major structural reasons behind the relatively equal income distribution, at least before 1980.

Obviously, the source of dynamism of small and medium business has been their links to the world market. Without this external market connection, the small and medium enterprises would not have grown at such a rapid rate, i.e. from 170,000 in the early 1960s to more than 750,000 in the late 1980s. One of the key policy mechanisms provided by the state's EOI to promote the dynamism of Taiwan's small and medium export business was the tariff and tax rebate system. Under that policy, the exporters were qualified to gain refunds on customs, duties and other taxes for the imports they required for export productions. This policy mechanism also helped to encourage Taiwan's exporters to be internationally competitive.

However, by focusing on this policy mechanism alone, one can be misled into believing that the small and medium enterprises have been given special attention by the state over the years. On the contrary, they have not been assisted financially in any other ways by the state, and they were left alone in their desperate efforts to be financed. For decades, the small and medium entrepreneurs had not been able to take advantage of the bank credit which went mainly to the state and big private enterprises. Only about 30 percent of the loans of Taiwan's bank system went to the small and medium enterprises (*Lin* 1989). As a result, they were forced to be heavily dependent on the informal money market for financial needs. Thus the massive and widespread informal financial market was critical to the survival and growth of Taiwan's small and medium enterprises, and provided more than 80 percent of their financial requirements in the early 1970s (Bello and Rosenfeld 1990). Even in the 1980s, the small and medium enterprises still had to rely heavily on various informal and private financial sources, such as rotating credit associations. However, these had much higher interest rates than the secured bank loans to which they failed to get access. According to a study report on the problems of Taiwan's small and medium enterprises, in 1991 more than 40 percent of this sector's financing still came from the private loan market (*China Time Evening Post*, April 5, 1992).

Clearly, the small and medium enterprises, in sharp contrast to the big businesses, have been peripherialized in the domestic political market *vis-à-vis* the state, even though they have been very active in their pursuit of material gains in the world economic market.

The evolving mechanisms of state-business relations

In order to develop a broader yet penetrating analysis of state-business relations in Taiwan's post-war era, one should first identify the relations of the KMT state to the market. Also, in understanding the state vs. market dynamics, the political nature of the state or regime should first be clarified.

As pointed out briefly in the previous section of this paper, the nature of the rule of the KMT regime on Taiwan since the war could best be characterized as "authoritarian corporatism". It is authoritarian because the party has dominated all political organs and rulers are selected without any due process influenced by popular preference or sentiment. It is corporatist because the state has chartered limited, hierarchical and subordinated interest groups in the civil society, giving them a monopoly of representation of various occupational or civil interests. Therefore, the state has been able to maximize the compliance and obedience of civil society under its authoritarian political system.

Such authoritarian and corporatist political rule and control over civil society has indeed provided the basis for the KMT state to assume a position of preeminence in the economy. Without ignoring the very political arrangements identified above, Taiwan's KMT state, in interacting with the economy, has been more than a "rent seeking regime". It did have a set of clear objectives for industrial development for different phases by employing relevant industrial strategies, such as the first ISI, EOI, and the second ISI. To make a more accurate characterization, Taiwan under the KMT can be qualified as an "authoritarian capitalist developmental state" in which the centralized state is equipped with not only corporatist arrangements but also effective development policies that can secure various economic development objectives.

The concept of "the governed market", as proposed by Wade (1990) after criticizing the neoclassical economic theorizing of the East Asian formula of the state and market relations, is useful and relevant to the Taiwan reality. Wade argued that the East Asian economic performance was due in large measure to a combination of: 1. very high levels of productive investment, making for fast transfer to new techniques in actual production; 2. more investment in certain key industries than would have occurred in the absence of government intervention; and 3. exposure of many industries to international competition in foreign markets. In this formulation the state—by using incentives, controls, and mechanisms—has been able to "guide" or even "govern" market processes of resource allocation so as to produce different production and investment outcomes than would have been achieved with either "free market" or "simulated free market" policies (Wade 1990). The emphasis on the dirigisme of the state in directing or influencing the market, however, should not be mistaken for a mere "market repressing intervention". As analyzed elsewhere, the most important aspect of such a model of dirigisme is not the authoritarian political control that has made Taiwan's development remarkable, but in spite of that political control (Hsiao 1992). Such qualification on Taiwan's state vs. market dynamics is crucial to the further understanding of the state and business relationship.

The bases of the KMT state's authoritarianism can be attributed to the following structural elements and control mechanisms (Chu 1989):

First, the KMT state has been tightly controlled by a highly coherent ruling coalition, with a hierarchy of small Mainlander power elites that rely on the Chiang-centered power bloc, and relied on a paternalistic patron-client network that was deeply rooted in the party-state structure until the death of the late president Chiang Ching-kuo in the late 1980s.

Second, ideological indoctrination has been great and effective and almost all cultural and educational media have been tightly controlled by the party state as the effective tools for such ideological domination both within the state apparatus and in civil society.

Third, the corporatist control employed by the party-state has been very widespread and powerful, occupying all organizational resources at different levels and realms of the society.

Fourth, the most physical and direct political control of the party-state has been the presence of a highly penetrating intelligence system in almost every government, military, and social sector.

The above political mechanisms by which the KMT state has aspired to maintain and strengthen its rule in Taiwan have had direct and indirect impacts on the economy and business as well.

Partly due to its ideological inclination and partly due to practical considerations, the KMT has established a material base for its political authoritarianism by directly owning a strong state party sector. Over the years, the financial connection between the government revenue and the party establishment has always been an open secret. With such material endowments, the state has enjoyed a more autonomous position *vis-à-vis* the private business sector. Moreover, through the economic bureaucracy, the state enterprises and the party corporations, the KMT regime has effectively coopted and integrated private business elites based on very political and differential considerations. The KMT has had absolute power in distributing almost all economic resources and profits by means of its policies and measures. Since the 1960s, the KMT state has been able to develop a developmental coalition with the big private businesses—first of Mainlanders and later of

Taiwanese. The exchange of political loyalty and economic benefits and privileges has been the principle that has consolidated the state and big business.

Therefore, it is not surprising to find out that almost all big private businesses and their founders have one way or another strong ties with the state or the party. If not necessarily all political ties, all big businesses have rendered their compliance and subordination to the authoritarian developmental state in order to maximize their business gains, primarily from the domestic market that was protected by the state's industrial policies. That is why, over the past four decades under the authoritarian rule, no big business has ever challenged the state in any political way. As pointed out, ethnic tension existed between the Mainlander-controlled state and the local Taiwanese-concentrated big business, and for that reason the Taiwanese capitalists were even more cautious when expressing any political opinion. They were perfectly aware that as long as they did not go overboard to challenge the state on political grounds they would be well taken care of by the equally sensitive state.

This is not to suggest that the consensual relations between the state and big business were based on genuine trust and confidence. Rather the tension between the state and business, and within business, has been carefully managed in order to avoid any uncontrollable conflict. In addition, though the state's official position was to protect the market for big business, the distribution of special privileges was in the hands of the state and the party bureaucrats. Under such a delicate situation, personal connections and networks became very crucial and the cultivation of personal trust between business elites and the political elites was essential for individual businessmen. The personalized business and state relations have further smoothed the potential tensions that could be caused by the overt political control.

Peng's study of the "quanxi" (relationship, connections, and networks) of Taiwan's big businessmen also found that the personal "guanxi" between the businessmen and the state elites or bureaucrats has been the base for the broadly defined political relations of the state with business. This was particularly evident among the first generation of big capitalists (Peng 1989). Nevertheless, the long lasting state and business relations are imbalanced, with the state in a preeminent position. To put it in a more accurate way, the state has exercised "paternalistic authority and dominance" over big business, and in this way the dirigisme or the resulting governed market was upheld and sustained until the recent political transition took place in the 1980s (cf. *Chang* 1991).

The other important mechanism that has shaped the paternalistic authoritarian state-business relations has been the state corporatist control at all levels of business associations. Such a corporatist control mechanism was effectively used by the party organs directly. Like in many other civil organizations, the party holds its respective organs from central to local levels to be responsible for supervision and surveillance. Within the private business sector, the national, provincial, and municipal trade associations were more or less the administrative or even party arms of the KMT state. The Department of Social Affairs of the KMT party headquarters has long possessed the decisive power in determining the outcomes in elections for key positions in the national trade associations, such as the National Federation of Industries (NFI) and the National Federation of Commerce (NFC). Not coincidentally, since the establishment of these two trade associations the chairmen have all been party members and all have been awarded the post in the Standing Committee of the KMT. Another cross-industrial and sectoral business association, The National Association of the Promotion of Industry and Commerce (NAPIC) has the same situation. This particular business association, organized in the 1950s, has been the forum for the big business elites and key state economic/financial officials in the form of monthly breakfast meetings. Again, it has also served the party's political purposes.

The NFI and NFC were in the hands of the Mainland business elites before the 1970s, whereas the NAPIC had Taiwanese business leaders in its governing body in the early 1960s. In a sense, the NAPIC was considered to be a corporatist mechanism for the KMT to integrate Taiwanese business elites (*Hsu* 1991).

Up until the late 1980s, the three national business organizations have all been the effective structures for the state's mobilization and control over Taiwan's big business sector. The pattern of the state's monitoring system over business was the same at the provincial and local levels. In addition, the tax and intelligence branches were the bureaucratic arms to keep business in check when needed.

At the local level, state-business relations added another political dimension, i.e. the local political factions. The KMT has employed several mechanisms to coopt or demobilize any existing local factions that might present threats to party-state rule in the localities. These means all share one common character: that is, the distribution of local economic resources and economic rents to the factions in a differential way (Chu 1989).

The first mechanism involved the use of arbitrary permission based on political considerations so that specific factions could dominate certain local economic activities like local bank branches, credit and cooperatives, producers' cooperatives, credit departments of farmer and fishermen's associations, and local bus transportation. A statistic has shown that among 89 county-based factions, 81 factions owned at least one of the above regional monopoly activities.

The second tool the state used was privilege loans granted by public banks. Almost all provincial assemblymen had access to such privilege with the party-state's permission. The third mechanism involved the use of contracts for public construction at the local level, and with these the local factions could maximize their gains. The fourth means was to benefit particular factions with a windfall profit under the guise of legal or administrative procedures, such as city planning or public infrastructure projects. Many land speculation schemes were in fact the common practices by which the local factions and political entrepreneurs could engage in exchange with the local or even the central party state bureaucracy.

The last scheme was one in which virtually illegal economic activities such as illegal gambling, dancing and prostitution establishments were protected by the local government and party.

One of the political consequences is that those local factions and political entrepreneurs at first grew bigger and stronger under the state's patronage and then later became a direct threat to the state's legitimate rule if the prices were not considered right by the factions. Towards the end of the 1980s, the growing tension between the state and the local factions and the local economic interests had become almost a constant problem for the party, meaning it had to negotiate and even comprise at every election. In other words, the clientelism that the KMT has relied on to deepen its domination at the level of local politics via economic rewards distribution was challenged by the empowered local political entrepreneurs when the overall authoritarianism was undergoing a transition to democracy at the national level. However, the tension was not necessarily driven by democracy. Rather, in most cases, it only reflected the ambition on the part of local factions to move for closer to the national political arena.

What happened to those small and medium enterprises that have been, for the most part, excluded from the political economic interest bloc that has protected the domestic market for big business and local political factions? As discussed in great length in the previous section, the small and medium entrepreneurs turned to the foreign markets for the economic opportunity and prosperity that existed in the world economy. The state policy provided incentives for boosting exports and the resulting gains for the export sector. However, it did not offer a deliberately favourable political environment for any particular enterprise to receive special privileges, as it had done with big business. The state also did not develop any sophisticated mechanism to integrate the small and medium business into its corporatist structure, as it had done with big business. Furthermore, small export businesses were not assisted by the state and public banking system when the need for finance was great, and all risks in entering the unknown world market were their own.

Without any elaborate state support or political blessing, small and medium businesses then turned to the traditional networks that existed in families and in interpersonal relations in order to get help for their business endeavours. The widespread family enterprises within the small and medium business sector, though dynamic and flexible in their response to the changing world market situations, have been limited in terms of growth and expansion due to the hands-off attitude of the state. The results of the small and medium enterprises geared for foreign markets have been very impressive. However, this remarkable achievement should not be misconceived as proof of the state's "correct" free market policy on Taiwan's economy. As analyzed in detail above, the state is by no means a free market follower in its deliberate intention to govern Taiwan's domestic market. It has also led to what *Hamilton* has praised—namely, the "strong society model" of Taiwan's state-business relations. In these relations the state has been "letting the people prosper" (Hamilton 1988). What should be qualified about Hamilton's assertion are the following:

First, under authoritarian corporatism, civil society in general and business in particular have never been strong *vis-à-vis* the state. Even though the dynamic small and medium enterprises later developed into a "strong" private sector and were relatively free from the state's heavy control, this still cannot be taken as a supporting evident. It was an unintended result and not the state's initial intention. Furthermore, in the course of export development, the small and medium enterprises were in no way in a position to be termed "strong" in facing the state bureaucracy.

If the business enterprise model is used to amplify the "strong" traditional networks of family and "quanxi" ties, and to justify the functional aspects of such a social and cultural foundation, one still should recognize the fact that the authoritarian and yet paternalistic state-business relations have in fact perpetuated the enduring traditional business practice and culture. For both big and small business alike, the KMT state has not been notable for its hospitality to business enterprises and they have developed a well-justified wariness and a well-honed set of defensive weapons to ensure their business survival in an uncertain and unkind political world (*Redding* 1991). Under the political circumstances, the family and the close ties are the first and last resorts, and to the small and medium businessmen the only resort for capital needs and management.

Second, the KMT state would let business prosper if the business rendered its political loyalty for economic gains. In big business, this is particularly evident. The state has let small business prosper from the world market rather than the domestic market, as the state has protected the latter for its big business client. This "letting small business prosper" in foreign markets is because the state has been preoccupied politically with the domestic market and left the door open for the politically weak small business to compete in the world economy without the state itself carrying the risks. Many small and medium enterprises have indeed prospered and made the Taiwan miracle possible, but it cannot be attributed solely to the state's genuine pro-small business ideology or strategy.

The most striking factor in the relations between the state and small and medium enterprises has been the lack of political calculation in their interaction, unlike the state-big business relations. The small exports manufacturers and firms, in their contacts with the state, were more on the bureaucratic level than on the political level, and they have very loose and indirect relations with the state. In the eyes of the KMT state, the scattered small scale businesses, oriented to economic opportunities outside of Taiwan, constituted very little if not a non-existent threat to the regime. Therefore, the state has not paid serious attention to the trade associations organized by small and medium entrepreneurs.

Being alienated from state-political connections, the small and medium enterprises, for their business survival and development, turned to the other two networks for necessary resources. This first is the family (kin) network and the other tie based on the "tung" (sameness) affinity, i.e. classmate, co-worker, provincial origin, the same local origins, and the same surnames, etc. The other kind of network involves marketing links with foreign corporations. The OEM arrangement based on subcontracting at the local production units has been the most popular link with the world markets through US buyers like K mart, Sears, J.C. Penny, H.P, T.I, IBM, etc, and the Japanese multinational enterprises. The Japanese marketing firms have played crucial roles in arranging and controlling Taiwan's exports, estimated between the range of one third to 50 percent (Lin 1989). The major Japanese trading firms that have operated in Taiwan include Mitsubishi, Marubeni, Mitsui, and the Beisei. The profits of the US buyers and Japanese traders from Taiwan's low export product prices have been significant, while the Taiwanese small producers have actually gained low profits and have been dependent on the foreign companies for world market links.

In other words, beneath the glorified picture of the dynamic small and medium export sector, that has been ignored by many official statements and economists' accounts are the marginalized political role of this sector unsupported by state credit policy and exploited by multinationals, the self-perpetuation of traditional business practices, the dependence on a high-interest informal money market, and the self-exploitation of themselves and their families. In the final analysis, under the "dual market structure" lies a "dual power structure" in which small business has engaged in "mutual exploitation" with other disadvantaged groups such as farmers and workers. On the other hand, big business and local factions with strong economic interests have exerted more and more influence at various levels of the state's decision-making bodies.

The transformation and the future prospects of state-business belations

After almost three decades of authoritarian, paternalistic yet protective state-big business relations, the "interests bloc" of the two important political economic sectors has been consolidated and deepened in Taiwan's social structures. Behind such consolidated state-big business relations were the growing political influences of the big business interests on the state's decision-making processes through direct and indirect means. It has been becoming more evident since the 1980s when the political liberalization and organized social movements began to take shape. It should be added that the increasing pressures placed upon the state by big business would be felt anyway as the situation was derived from the spread effect of accumulated capital. However, as state authoritarianism has been greatly affected by the demands of political democratization that originated from the larger civil society, the growing political influences from big business have become much more visible and intensified (Hsiao 1992b). In other words, the consolidated state-big business relations in the 1980s also witnessed an unprecedented transformation.

The most noticeable indication of the increasing visibility of direct business participation in Taiwan's politics can be found in the growing active involvement in national elections of the capitalist class since the 1980s. The increasing seats held by the business elites in Taiwan's law-making body, the Legislative Yuan, has been most significant. As Kuo (1991) has demonstrated, based on the calculation of the class origins of candidates and elected Legislative members from 1972 to 1989, in sharp contrast to the working class and the middle class, the capitalist class has occupied more and more seats over the past two-decade remained period. Though the percentages of candidates with chief employer backgrounds remained stable (21–25 percent) in that period, the percentages of elected seats controlled by them noticeably increased from 19.4 percent in 1972 to 30.6 percent in 1989. Kuo's study further shows that if the chief employers, the proprietors and other big businessmen are grouped together as the capitalist class, then more than 45 percent of the current Legislative members represented capitalist interests in 1989. Moreover, there has been a great increase of commercial and financial capitalists holding seats in this law-making body, while the manufacturing industrialists have remained the same without much change. As discussed above, the empowerment of the Taiwanese business class has also been reflected in the changing ethnic composition of the Legislative members since the 1980s. Finally, the KMT was much more inclined to endorse capitalists and big businessmen as party candidates for various elected posts in the 1980s.

Moving from central level politics to the local political arena, according to Chen's class analysis of the provincial assemblymen between 1968 and 1985, the capitalists and top executives from both private and public enterprises constituted as much as 75 percent of all the seats. This further demonstrates the over-representation of this class interest even in the provincial law-making process (*Chen, M. T.* 1990). Such observation can also be supported by another calculation showing the occupational backgrounds of both provincial, county, and township councilmen who were elected in the 1970s and the 1980s (*Chen, S. F.* 1988).

Therefore, it is quite reasonable to conclude that under the authoritarian paternalistic state rules, Taiwan's business class (especially the big ones) has been fostered greatly in numbers and has gradually been moving towards participation at all levels of politics. The big businessmen have concentrated their political influences at the central level, while the local factions with strong business-economic links at the local level. As for the large number of small and medium entrepreneurs, over the years, they had virtually been excluded from the political process at the central level, though some did get involved in local politics. Compared to their big business counterparts, the small and medium businessmen were in a peripheral position, and thus outside of Taiwan's domestic political mainstream.

With more and more visible and stronger representations at the central level of the political decision-making process, big business interests have been further protected and even received further promotions at the expense of other social and public interests. Since the 1980s, a number of the state's industrial and financial policies or laws have been made in favour of big business interests and some have even been blocked or deferred under the great influences of those legislative members working on behalf of the big businesses. The former cases include: the Ministry of Economic Affairs' new policy change (1984) in the code of regulating the textile exports. At first this was resisted and later modified extensively in order to protect the vested interests of big textile industrialists; there was also the Ministry of Finance's decision (1989) to recollect the tax on stock exchange profits, which was strongly opposed by the "stock legislative members". Finally the Ministry receded by reducing the tax rate from the originally planned 1.5 percent to only 0.6 percent, in order not to upset the ever-growing financial capitalists (cf. Kuo 1991).

Other cases include the strong resistance of capitalist interests in the Legislative body to the state's decision to enact the Consumer Protection Law, Environmental Protection Law, Fair Trade Law, and the Environmental Impact Assessment Act. Though the Fair Trade Law was finally passed in 1991 after more than a ten-year delay in the Legislative Yuan, the other three are still pending as they were perceived by many elected capitalists members to be threatening to business interests.

Even with the enacted Fair Trade Law, big business interest groups still take a wait-and-see attitude. The social-economic objectives of this law are to regulate big business practice and to avoid or minimize the social inequality caused by the overexpansion of business conglomerates. However, the big business elites believe the state companies and party enterprises with heavy state protection and special political privileges should be regulated in a more vigorous manner. In other words, a certain degree of resentment is shared by the business elites, towards the state's apparent "anti-business" sentiment in enforcing this law. Certainly, such negative attitudes are not shared by the larger non-business population.

What has been observed is a seemingly weakened state making autonomous policy decisions *vis-à-vis* the big business interests, and the state has then been forced to compromise with pressures coming from the once subordinated business sector. The Legislative Yuan, the highest law-making body in Taiwan, has been increasingly controlled by many elected capitalist members in making decisions on economic and financial matters, due to the fact that the business and capitalist interests have almost dominated the Economic Committee and the Finance Committee of this body.

The liberalization of the authoritarian KMT state, as demanded by the political opposition and social movements since the 1980s, has already transformed the state from hard authoritarianism to soft authoritarianism. In the process of adjustment of the proper role and function of the state bureaucracy, the old rules of the game are no longer useful for the state in trying to govern the civil society at large. When the state began to adjust itself to be more responsive rather than being domineering in facing various and often conflicting demands from civil society, the powerful interests groups could usually take more advantages of the state's bemusement at the time. In fact, this has been the case with the transformed state-business relations since the 1980s.

To put it more critically, although it was the non-business sector of civil society and the opposition in political society that forced the authoritarian KMT to liberalize, it has been big business and capitalist interests that have benefited financially the most from the political liberalization. Big business was able to protect its gains in the domestic market under authoritarian rule; yet, during the liberalizing and democratizing episodes, the big business has again been better equipped to exploit situations to either minimize its losses or maximize its possible gains. Sadly to say, under both the authoritarian and the democratizing regimes, it seems that big businesses could always come out on top.

However, the small and medium enterprises have not been so fortunate in the course of political transformation. In the 1980s, the export manufacturers faced many internal developmental problems, like labour shortage, rising labour costs, and escalating land prices. They also experienced external threats from Southeast Asian manufacturers, competition and protectionism from the west, and finally their competitiveness has been reduced in the world market further due to the valuation of Taiwan dollars since the mid-1980s. The official policies adopted by the state to deal with the development problems included industrial restructuring of labour-intensive and high-tech industries, diversification of trade in the world market, and the transfer of labour-intensive industries from Taiwan to the Southeast Asian region. However, these policies have not been able to solve the immediate and desperate problems that the small export producers and traders have confronted—that is, how their businesses can survive in the short-run. To the small export manufacturing firms, the pronounced state polices were at best a long-term solution to Taiwan's industrial development, but not a workable and effective remedy for their very survival difficulty. In other words, during the bad time since the 1980s for the small export manufacturing businesses, the state has not rendered much quick and substantiative help. They have had to, once again, rely on their own efforts to survive.

As they did in the 1960s and the 1970s, in order to take chances in the foreign markets for exports, so in the 1980s, they again took risks to explore the labour market in Southeast Asia and Mainland China so that they could strengthen the chances of their own survival by transferring or expanding their production operations there. In Southeast Asia, it is the traditional Chinese network and not state assistance that has helped them in their business ventures. In Mainland China such trade and investment by Taiwan's businessmen was legally prohibited in the early 1980s. Thus small and medium entrepreneurs risked their property and the danger of punishment by the KMT state. They were the first group to engage in "unofficial" economic relations with the Mainland. The self-made spirit, quick response to new opportunities, and the daring to risk their own money and possessions have, once again, helped the small firms get into the "foreign" markets outside Taiwan.

In the late 1980s and the early 1990s, the KMT state endorsed—albeit reluctantly—a series of more open policies toward Taiwan's trade and investment with Mainland China. The state finally recognized the reality of active Taiwanese trade and investment on the Mainland and further modified its mainland policy in a pragmatic direction. A cabinet level Mainland Affairs Council was established and a semi-governmental Straits Exchange Foundation was formed; both are responsible for future policy-making and implementation at official and civilian levels. The Straits Foundation has been established by the KMT to be a mission with "front line" contact with PRC officials in dealing with civilian and business disputes that have occurred or might occur in the future.

In retrospect, behind the changed Mainland policy of the KMT state, one can find the large influence of the big capitalists' initiatives and pressures (*Hsiao and So* 1992). It was only after big business entered into Mainland investment and developed vested interests there, and only after they had begun to exert pressures on the state through various effective channels, that the state shifted its mainland policies to more pragmatic ones. President Lee Teng-Hui, unlike the late Chiang Ching-Kuo and his father Chiang Kai-Shek (who both had an anti-capitalist, anti-business ideology) is known for his favourable attitudes toward business and he has a list of close Taiwanese big business friends. He has often consulted with them on many economic issues, and trade and investment policies on Mainland China are certainly the main concerns at present. Beside these direct influences on the president from big business interests, the Legislative Yuan has also served as a source of pressure on state officials through those elected capitalist members who have demanded a more liberal and open system of trade policies towards the PRC. The close relationship between the KMT and big business on the Mainland issue was also revealed by the fact that many influential capitalists made donations to the Straits Exchange Foundation and served as board members.

The small and medium enterprises initially opened the Mainland market at their own political risks and made the profitable reality known to big business, and later big business followed with greater financial and political power. Under the more flexible Mainland policies, though the small manufacturers have also benefited, they now have to face competition from their fellow big businessmen on the Mainland for labour and raw materials. These can easily be taken away by the financially powerful big business operations. Furthermore, they are also worried that their existing privileges to do business on the Mainland by informal means, like many back door tactics, may disappear once the communication and relations between the two sides are officially institutionalized as having been actively pushed by big business interests.

It is someties heard that some Taiwanese manufacturing investors in southern China have either been killed or kidnapped for financial-related reasons and that what the state in Taiwan could do to help or to prevent such things was limited due to the unclear political relations between the two sides. So there are some "self-reliant mutual aid associations" organized by Taiwanese small and medium businessmen in different localities of southern China, where Taiwanese capital is concentrated (*China Times Evening Post*, March 17 1992). What has been seen about Taiwan's small and medium entrepreneurs, is that the struggle for survival over the past three decades of exports drive has been constant and persistent. Without any significant assistance or special privileges from the state, the Taiwanese small business have survived various crises, and they have done it by themselves. They could not, as the big businessmen have usually done, ask for help from the state authority. Constrained or inspired by the unfavourable state-small business relations, they had to be prepared for any possible crisis internally or externally. They were in no position to exert any substantiative pressure on the actions of the state, either on individual capacity or through collective action. By and large, for most small and medium enterprises, political liberalization has not so far improved their bargaining positions *vis-à-vis* the state power in any direct manner.

One should not, however, evaluate the overall impacts of Taiwan's political transition from authoritarianism by looking at its repercussions on the state's relations with business. The weakening autonomy of the state's economic and social policy-making in facing strong and organized pressures from big business interests has caused some alarming signs. To many concerned critics, the transformed state–big business relations favour the latter and, at the expense of the general public interest, these have indeed been the crucial factors in the worsening the social inequality in Taiwan since the 1980s. This is not to suggest that the pre-liberalization state-business relationship was a better one. It simply points to the problem that the state has been trapped in the political-economic setting that it created itself in the past, and the costs incurred were then transferred to the society as a whole. The state, in its intention to bring back big business under its patron–client arrangements, has not only made concessions to big business interests in various policies, but has also engaged in a number of aggressive actions to win back the support and political loyalty of business.

Since General Hao Ber-Chung took the power as premier in the middle of 1990, there has been a compromising political power distribution of the intra-party struggles between reforming and conservative factions and between Taiwanese and Mainlander ethnic lines. The state has started to take tougher positions in responding to the demands from social movements—such as the labour movement and environmental movement—that have had threatened business interests. Criminal codes were applied to suppress the activism (brought about by the mobilized civil society) expressed in the form of organized social protests.

Second, in order to win business confidence, the state insisted that it go ahead with the controversial industrial projects that have been objected to and effectively halted for some years by the opposing environmental groups and local residents. The typical examples are the questionable industrial zone in central Taiwan, the China Petroleum Company's construction of the fifth Naptha Cracking Refinery in the South without having solved the serious pollution problems already caused in the local community, the Formosa Plastics Group's planned new petrochemical refinery in the Southwest coastal area, and the most debated fourth nuclear power plan to be constructed by the Taiwan Power Company in Northern Taiwan. All these actions represent an attempt to strengthen state power and to develop a new developmental coalition with big business.

Third, in mid-1991, the ambitious Six Years National Construction Plan was launched by the premier with a total budget of NT 8 trillion dollars (about US$ 320 billion dollars) with dual political-economic purposes—i.e. to strengthen Taiwan's links with foreign capital and to further tighten up big business political connections with the state by sharing this newly created economic pie.

Fourth, in a politically more direct way, the party state began to search for a new coalition with the rising business elites who are either the successors of the well-established big business or the emerging successful entrepreneurs in various business sectors, including a few important electronic and computer manufacturers and exporters. The newly organized fourth cross-sectoral business association, the Association of Industrial and Commercial Development (AICD) is a good case in point. The members were hand-picked participants in a KMT-sponsored business leaders training programme. The AICD is quickly emerging as an organized collective force on behalf of the rising business elites, in addition to NFI, NFC, and NAPIC. The latter are still controlled by the elder generation of business leaders. In a sense, the AICD can be viewed as an organized forum by the younger generation businessmen, enabling them to compete with the older ones for political influence. Since the AICD has many successful medium exports businessmen as members, it can also be seen as a move to cultivate the domestic political market that has long been dominated by the big business establishments. The party-state, on the other hand, certainly sees it as an opportunity to use it to check the over-powerful big business interests. It is therefore important to see how the AICD will interact with the state power and how it would shape the future directions of the already changed state-business relations.

Fifth, beside the attempt to develop a new alliance with the new business elites, the state also tried to restrengthen its political control over business by expressing its disapproval towards some business support for the opposition Democratic Progressive Party (DPP) and its activities. In a speech to a group of important business leaders in September 1991, Premier Hao warned his business audience in a rather coercive tone not to support the DPP-backed Taiwan Independence movement. Though such an overt political statement was later severely criticized by the DPP and public opinion, the intention behind such a political move cannot be ignored.

So far, the increasing political capital possessed by big business has helped it in its accumulation of economic capital during the course of political transition from authoritarianism to democracy. However, it has further weakened the KMT state's relative autonomy *vis-à-vis* civil society. Yet the state, in responding to such an unprecedented challenge, has shown its biased attitudes by conceding to big business interests on the one hand, and by repressing the demands for further social and economic reforms made by the social movement sector in the civil society, on the other hand. It may be unfair to say that the liberalizing state has not relaxed its control over civil society. By lifting various bans on civil organization, the press, and specific religious organizations, the state has responded to demands for liberalization from society and has tried to be more responsive to the needs of various segments of the general public. However, what is at issue here is not the mere softening of the tight control on the society, rather it is whether or not the state has redirected the source of its political legitimacy to more broader and more democratic bases. Essentially, the transition to democracy requires a reorganization of the overall state-society relations in a more balanced and egalitarian direction.

In this sense, the liberalization of the authoritarian KMT state was exploited by the transformed state-business relations in order to expand the political and economic interests of big business and not for general well-being and social justice. The new kind of state-society relations have not yet been institutionalized and, unfortunately, the state has not shown any definite sign to move in this direction. Instead, the state took a different direction in still narrowing its political base in the business sector by either restrengthening its ties with big business or extending its coalition with the newly emerging business elites from the export sector. The even more crucial task and challenge to establish a genuine democracy in Taiwan by institutionalizing the broadened bases in the resurrected civil society certainly has not been met by the seemingly weakened state.

The emerging social movements, despite their primary objectives aimed at political liberalization, in calling for more social equality and economic justice, could serve to prevent the weakened state from being charged by the increasingly powerful big business interests. In other words, the emerging social movements not only just press the state to loosen its control over society, but also demand that the state redirect its class and sectoral coalitions. The state could, in a way, develop a social coalition with the social movements as a backing to reshape its distorted relations with big business interests.

The crucial tasks before the KMT state at present are to learn immediately and thoroughly the new reality. To organize and accept the irreversible trend towards democracy should be a precondition to the reformers within the political centre in order to generate popular support and even to accelerate further democratization. As for the future state–civil society relations, the state should identify the new social interest groups that have emerged in the different social movements, and readdress the existing corporatist structures that have long been the licensed representational monopoly within their respective social groups such as farmers, labourers, intellectuals, business and others. The existing limited number of hierarchical and subordinated corporatist structures inherited from the previous authoritarian rule have been more and more alienated from their constituencies and have even become a target of opposition. Recognizing the new elements and social forces in the different sectors of the mobilized civil society is to accommodate the demands from the social movements and to actively engage in a societal transition from "authoritarian corporatism" to "democratic corporatism". In such a model of state–civil society relations, though the state does not assume a unified state direction and control, it can assume a more autonomous position without being manipulated by one particular dominant class or a powerful interest group.

This seems to be the most desirable prospect for the future model of Taiwan's state–civil society relations, of which the state–business relationship is an integral part. To envision such a prospective model, new government agencies should be established, the old agencies should either be expanded or reorganized, and a new style of bureaucracy should also be fashioned. By so doing, the state can then effectively respond to the increasing social demands and interest articulation from the broader civil society and not just the big business class. Thus it can make it compatible with long-term political democracy and social justice for the society as a whole.

Only after this task or challenge is fulfilled and met by the state, can the internationally praised political liberalization be firmly guarded and lead to bona fide democracy in Taiwan.

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COMMENTS AND CRITICISM

THE POLITICS AND ECONOMICS OF REFORM REFLECTIONS ON JÁNOS KORNAI'S NEW BOOK

W. BRUS

1.

János *Kornai* has a well established—front—place in the world of scholarly analysis of the communist economic system, and his latest book (Kornai 1992) adds considerably to this stature. It does so not merely by bringing together, refining and carefully structuring all what the author contributed to our knowledge of the anatomy and the physiology of the socialist economy in the past, but also by presenting important new insights into the operation of both the "classical" version and of the reformist attempts of "shifting from the classical system". Foremost among these new insights is the inclusion of the ***political factor*** into the ***economics*** of socialism in a way that makes it a part and parcel of the economic analysis, reflecting the real role political power plays in real life of "real socialism", i.e. in countries ruled by the Communist parties. In this respect the book lives up to its subtitle: it is a genuine *political economy* of Communism.

As the author tells us in the Preface, he began writing the book when "power in the countries of Eastern Europe was still in the exclusive hands of the Communist party", and was ending it in the spring of 1991 when Eastern Europe was fully immersed in postsocialist transformation, while the mighty Soviet Union was soon to disintegrate. In other words, the book was written in the course of probably the deepest and swiftest metamorphosis of the systemic and international scene even our eventful century has seen. And yet Kornai—firm in his belief in the value of positive (as opposed to normative) approach to the analysis of economic systems—keeps his distance from the current problems of transformation: not only there are no "prescriptions" how best to guide the former communist economies into the unfamiliar world of the market and private property rights, but even the problems faced are pushed aside as a matter of principle, except very brief sections ("previews") at the end of most of the chapters of *Part Three* ("Shifting from the classical system") which register the legacy of the communist past and in this way map out some of the starting points of postsocialist transformation. This means that the dynamic aspect of the socialist system, its propensity to change or lack of it is discussed mainly within the confines of *reform*.

Kornai has displayed profound scepticism with regard to the ability of reform to produce an essential cure for the "classical" socialist system's ills in his previous writings, especially in the article about the reform process in Hungary (Kornai 1986). In the present book the analysis of reform goes much further, both in width and in depth. As far as the width (scope) is concerned, it is not limited to Hungary (and implicitly, to the likes in Eastern Europe) alone, but covers the entire spectrum of "real socialism", including the Soviet Union under Gorbachev, and—most significantly—China. As far as the depth is concerned, the reform is submitted here to the full instrumentarium developed in the course of theoretical scrutiny of the "classical" system: the five blocks of its cardinal features (power, state ownership, bureaucratic coordination, soft budget constraint, shortage and closed economy), with the main line of causality running from the higher to the lower placed ones (in diagrammatic presentation—from left to right, see p. 361). Thus, block 1—"Undivided power of the Marxist-Leninist party; Dominant influence of the official ideology"—is decisive: "The prime factor that brings the other system-specific phenomena about is the undivided power of the Communist party imbued with its specific ideology" (p. 361). Kornai carefully distinguishes between reform and two different courses of action which are often presented under the same name: on the one hand, a reform ("genuine reform", "true reform") is more than merely attempt at "perfection" of control—trying to make the same mechanisms operate more efficiently, for instance by reorganization or computerization; on the other hand, reform, changing some essential features of the system, aims at preserving the fundamentals: "I term a *reform* any change that permanently and essentially alters at least one basic attribute of at least one of blocks 1, 2, and 3 (political structure, property relations, and coordination mechanisms), but without taking the system out of the family of the socialist system... When the most radical change possible occurs in the deepest link in the causal chain, the political structure—when the Communist party's monopoly of power is broken—the change "crosses the Rubicon". It is not a reform any more, but a *revolution*" (p. 388).

Kornai's verdict on reform (in the strict sense) does not change after x-raying it thoroughly with all his theoretical instrumentarium. The concepts of a reformed socialist system, particularly "market socialism" which attempts to combine market coordination with dominance of state ownership, display a degree of incoherence which disqualify them not only as designs of "third road" systems (neither "classical socialism" nor capitalism) but even as a relatively stable and successful transitory stage: liberalization is not consistent and does not develop fully, revival of private sector takes place only in a narrow segment of the economy, the coordination mechanism changes from direct to indirect bureaucratic coordination and not to the market one, etc. The consequence of the reform process is actually an increase in macroeconomic tensions, if not immediately so after some time: "Sooner or later, even in the relatively most successful reforming countries, the trend of improvement is broken, and in the less successful ones it never really develops" (p. 560). All in all, the results of the examination are taken as full corroboration of the proposition put forward at the very outset: "The book's ultimate conclusion on the reforms is a negative one: the system is incapable of stepping away from its own shadow. No partial alteration of the system can produce a lasting breakthrough. For that a change of system is required" (p. xxv) Moreover, the reformist experience up to now provides a practical test of soundness of the general theory of the socialist system, as presented in the book, because it "confirms the theoretical statements made about the main line of causality" (p. 569).

2.

The strength of Kornai's reasoning and conclusions is undeniable. It has been acknowledged by most of the "naive reformers", as Kornai called them in his 1986 article cited above, this reviewer including (*Brus* 1989). In the European "people's democracies" reforms have failed one after another, and the conclusive shift to a market economy began only after removing the Communist parties from power, i.e. after a political revolution. The most spectacular case of the same sequence turned out in the mother-country of Communism—in the Soviet Union—where the march towards the market economy started in earnest only after the failure of the August 1991 coup. So, it would seem there is nothing what a reviewer could do but to acclaim the conclusions, the underlying analysis and the theoretical apparatus used for this purpose. And yet I feel some degree of discomfort when trying to put at this point a full stop to my assessment of Kornai's book. What bothers me are two interrelated problems: how sharp is in all cases the dividing line between economic reform and revolution, and how legitimate is the unlimited generalization of "the main line of causality", particularly the proposition that any real shift away from the "classical" system must start with liberalization (reform) or complete overhaul (revolution) of the political structure? My impression is that the dividing line drawn as universal in the book is too sharp, and that the generalization concerning the role of the political factor should not go unqualified.

In both points the experience of China seems to me of particular significance, although the Hungarian pre-1989 reform process might also be regarded as blanding the division somewhat (Kornai acknowledges its role in preparing the ground for the resolute, revolutionary move to a market economy); if not for the tragic cast of its disintegration, Yugoslav reform—in itself equally unsatisfactory as the Hungarian—would have probably become a similarly positive preparatory stage. But the Chinese case clearly stands out.

Block 2—property—is of particular interest in this respect. The fact that the reform began with a fundamental change in property in agriculture—privatization in anything but name—is well known, and its significance for the overall marketization of the economy—bearing in mind the weight of peasant agriculture in China—is commonly acknowledged, particularly when it became soon accompanied by lifting most controls over prices, as well as over the structure of production and sales (gradual elimination of quotas). Perhaps less known, although awareness of it is growing rapidly, is the scale of development of non-state enterprise sector ***outside agriculture***, particularly in the countryside and in small towns (township/village enterprises), but also increasingly in urban, including metropolitan, areas. These enterprises are mostly collectively owned, although there are among them also straightforward private enterprises, as well as mixed ones (the state as co-owner), and of course joint ventures with foreign capital. The size of this sector (measured by output and employment) has grown over the period of reform (since 1979) much faster than the state sector's, resulting in constant increase of its share in the national economy: in 1989 the share of the non-state sector in total employment ***outside agriculture*** was estimated as 58%, and it accounted (1990) for 45% of total ***industrial*** output, and 60% of retail sales (1988).[1] Since then the specific weight of the non-state sector outside agriculture grew further. This sector would probably be refused the name "private" by purists, but it behaves predominantly like private business, and it exerts an enormous "marketizing" influence on the economy as a whole. Taken together with the decisive change in agriculture, as well as with the ownership consequences of the "opening to the outside world", can it really be still maintained that in this case of a reforming economy the "upheaval in ... property relations" takes place "only in a narrow segment" (p. 566)?

How does this affect Block 3—principle of coordination, bureaucratic versus the market one? Kornai, rather curiously, confines the discussion of this point (including explicitly the Chinese case) "solely to the public sector" (p. 479). Indeed, the state sector in China has remained intact as far as the ownership question is concerned. No "privatization from above" (transfer of state enterprises into private hands) has occurred, so far, in China, and it does not even appear until now (end of 1992) on the official agenda of further reforms. Many of the familiar features of the situation of state enterprises under a command system are still present: job security (hence overemployment), responsibility for providing social services, numerous aspects of "soft budget constraint" (subsidization, bailing out of loss-making firms etc), prevalence of bureaucratic appointment of managers. All this obviously brings about the familiar headaches of low efficiency, pressure on the budget, bargaining for resources, and other negative phenomena. On the other hand, however, significant changes took place also here, reflecting the overall marketizing trend and contributing to its assertion. I have in mind in the first place the so called "dual track" system whereby target planning and state allocation of resources is preserved for a given limit of productive capacity, while "above quota" output is freed with regard to the direction of sales, sources of supply, and—most importantly—pricing. It may be surprising for some what scale the proportion

[1] Figures for the share in employment are from *Wood* (1991); for industrial output from *McMilland and Naughton* (1992); for retail sales from *Lardy* (1991).

of the liberalized sphere of the state sector reached: by 1989 34% of output of finished steel, 49% of coal, 51% of trucks, 78% of metal-cutting tools, 88% of power-generating equipment, 61% of tractors (Wood 1991). Needless to say, the "dual track" policy has not eliminated the usual weaknesses of the state sector mentioned above, and has inevitably created new problems by opening the door to corrupt exploitation of the clash between two different principles of operation. Nevertheless, on balance it has fostered the cause of marketization: in the short term—because it injects some dose of business behaviour into the management of state enterprises without waiting for change in ownership structure and without threatening to produce major social tensions by abrupt cessation of all forms of "paternalism" which could inter alia lead to massive surge in unemployment; in the long term—because it paves the way, both ideologically and practically, towards full subordination of the present state sector to market coordination.

Apart from the "dual track", a major (some would say *the* major) role in marketizing the state sector is played by foreign economic relations (continuous extension of the right to trade directly, production joint ventures and financial partnerships), as well as gradual broadening of the sphere of enterprise investment activity (genuine—not formal), participation in the fledgling capital markets etc. The case of Shougang Corporation (large steel company at the outskirts of Beijing) is perhaps still unique (full autonomy not only over output, sales, prices etc. but also over investment, including foreign acquisitions—the company bought a 51% stake in a major Hong Kong steel distributor, as well as a converter steel making plant in California), (*Financial Times* 1992) but it shows the trend which brings full-fledged market mechanism into the hard core of the economy, and not merely to "special economic zones".

In spite of all this, I would probably still hesitate to claim that the Chinese economy has already switched over from bureaucratic to market-coordination. But I would also (this time firmly) refuse to accept in this particular case Kornai's generalization that a reform can achieve only a change from direct to indirect bureaucratic coordination. The author's statement to this effect in the book reviewed (p. 488) is consistently limited to the public sector, which may be formally correct even for the present-day China, but it seems hardly illuminating for an overall assessment of the reform process. In my view we face here a case in which the distinction between reform and revolution in the economic system becomes increasingly blurred.

Also in respect of the increase of macroeconomic tensions the Chinese reform process seems, so far not to corroborate Kornai's predictions. Of course, they were up's and down's over the period in question, and from time to time the danger of overheating the economy became quite serious. But the destabilizing factors were not allowed to get out of control, the official inflation rate did not exceed 18% for any one whole year since the beginning of the reform drive, and even allowing for the usual distortions, the "true" rate of inflation hardly ever climbed at its peak above the 25–30% per annum—a far cry from the Soviet and European rates; the same can said about control over foreign indebtedness, and—most remarkable—about the ability to avoid "dollarization" of the money circulation, so typical for economic destabilization. At the same time all major indicators (growth of GDP, investment, foreign trade etc.) point—again, usual qualifications as to the reliability of the statistical data notwithstanding—invariably to strong, even exceptional dynamism, accompanied by unmistakable improvement in living standards of the population. Admittedly, one can never be sure of the future, but by now—after almost a decade and a half since the start of the process—there are no signs of the economy exhausting the initial boost to performance and entering the downwards stage; if anything—the opposite seem to happen, the deepening of the systemic changes and improvement of economic performance fuelling each other. I am aware that some special factors may be at play in the Chinese case, but (i) special, country-specific, factors operate everywhere, and (ii) the intention of my remarks is not to deny the validity of the book's conclusions on the matter of reform and revolution, but to open to question their universality.

3.

The same applies to the second point of my discussion: the proposition that real changes in the economic system are pre-conditioned by political liberalization. I must stress here that by challenging the universal validity of this proposition I take issue not only with János Kornai, but with myself as well: in numerous writings I argued (along with most other East European reformers) that no meaningful change can occur in the socialist economic system without political pluralization, i.e. breaking up the power-monopoly of the Communist party (Brus 1980). As mentioned already at the beginning of the preceding section, the events of 1989/91 in Eastern Europe and in the former Soviet Union appear to have fully vindicated this argument. And yet, not all seems quiet on this front ...

Problems mount with particular intensity when one compares the development of reform in the Soviet Union (it existed then, so the adjective "former" can be dropped) under the Gorbachevian "perestroika" with that in China. Kornai seems to neglect the differences between the two, or at least to regard them as not significant enough to merit emphasis and special scrutiny: "Just as the socialism of Stalin, Mao Zedong, and Rákosi is existing classical socialism, so the reform socialism of Tito, Kádár, Deng Xiaoping, Gorbachev and Rakowski is existing market socialism" (p. 480). According to argument above, "market socialism" of Gorbachev clearly differed from that of Deng Xiaoping in terms of economic effects, the former corroborating to the maximum Kornai's expectations of increased macroeconomic tensions, the latter foiling them perhaps with equal strength, so far.

But the most telling, and—from some point of view—the most disturbing aspect of the differences in depth, consistency and effects of the reform process in the two economies is that they were *inversely* correlated with the postulated changes in the power-block 1: "Perestroika", after some initial hesitancy in the first year of Gorbachev's general secretarship, actually started from the political liberalization end, and made *real* progress mostly in this very sphere, while marketization and privatization of the economy remained largely on paper or in the state of growing confusion. In contrast, the Chinese *political system* remained basically intact throughout the reform period, sometimes even reversing the expected direction of change while the economy was being pushed further along the reform track (cases in point include the dismantling of the "Democracy Wall" in 1979, the campaign against "spiritual pollution" in 1983, as well as the intensification of the market reform after the 1989 Tiananmen-square massacre). It looks therefore that, at least on the basis of the evidence available so far, the proposition of incompatibility of economic system reform with political totalitarianism in which the Communist party leadership remains the sole repositary of ultimate power, cannot be taken for granted. I don't think it appropriate in the format of a review article to consider a stronger point of the "perestroika"-Chinese reform comparison, namely the possibility of the Communist power monopoly ("mono-archy") making a positive contribution to marketization; it is a complex issue, but the different degree of ability to cope with similar kind of macroeconomic tensions in the Gorbachevian Soviet Union on the one hand, and in the reforming China on the other may make the revision of the conventional wisdom here quite plausible.

Once again the reservations related to special circumstances should be kept in mind, particularly in this instance the enormous gap in the developmental levels between the Soviet Union and China at the start of the reform process. However, apart from the usual difficulties to reconcile the specific and the general already mentioned, it is worth stressing that the Soviet Union–China comparison should not be regarded, in my view, as just ordinary cases on a par with all the other ones. We deal here with two giants of communism—of great weight on a world scale not only because of their size and power, but also because the communist revolution there could claim strong endogenous roots, unlike Eastern Europe where it was basically—perhaps with partial exception of Yugoslavia—imposed from outside. That is why the interaction between economics and politics of reform in these two countries seems to have much greater relevance for establishing (or not) regularities of the move away from the "classical system" than elsewhere.

One crucial point must be clarified at this stage of our discussion of some of Kornai's propositions concerning the relationship between politics and economics of reform: what is actually the deepest layer of causality, the ultimate core of block 1 which supplies the "genetic program" for bringing the socialist system into being, and whose modification is indispensable for deep, radical and persistent change in the whole organism (pp. 568–69)? In the general theoretical presentation (chapter 15) and throughout almost the entire book the two components of block 1—undivided power of the Communist party and the dominant influence of the official ideology—appear jointly, inseparably like Siamese twins, and the reader is given a firm impression that the *official* ideology is that of construction and later at least preservation of the "classical system". But in chapter 24 (concluding remarks on reforms) a possibility of some kind of separation seems to enter the scene: "So long as the Communist party is in power, the system can move away from the classical system if the party makes the alteration itself, or at least tolerates it. It then co-opts the change into the system's official ideology, or makes an ideological concession and ignores the phenomena that conflict with its ideas" (p. 565). A few pages later: "A considerable change must take place in the thinking of the Communist party leadership before it can bring itself to make an appreciable departure from the classical system, or at least resign itself to such a departure taking place" (p. 570). Should such separation be incorporated into the "causal chain", our entire topic of dispute would simply disappear because the possibility of real change in the economic system would depend not on the change in the political structure (liberalization, democratization, pluralization—whatever term looks more appropriate) but on the change in the Communist party's ideology or strategic thinking. Thus, if—as it seems to be the case—the Chinese Communist party became persuaded (or cajoled) by Deng Xiaoping and his associates that *in order to preserve* the "undivided power of the Communist party" it has to embark upon another "long march", this time towards a fully fledged market, perhaps even capitalist economy, only verbally veiled by the slogan "socialism with Chinese characteristics"—little, if anything, is left of the "undivided power of the Communist party" as an unsurmountable obstacle to profound change in the economic system.

Of course, a powerful line of defence still remains: can the relatively successful marketization under a totalitarian polity be extrapolated into a longer term future? A number of reasons for doubts may be advanced here: Will the party-state reconcile itself to continuous shrinking of its authority over the economy? Will the rule of law (Rechtsstaat), indispensable *inter alia* for establishment of property rights, be compatible with the "leading role of the party"? Will the social consequences of continuing marketization not force ultimately a pluralistic transformation of the political system? These, and similar ones, are legitimate questions, but they go beyond the framework of the positive theory developed in János Kornai's book.

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REVIEWS

FOREIGN ECONOMIC LIBERALIZATION IN EAST-CENTRAL EUROPE: THE EXPERIENCES OF POLAND AND THE CZECH AND SLOVAK FEDERAL REPUBLIC*

L. G. TÓTH

In the programmes of economic transformation in the post-communist countries, liberalization of foreign trade plays a major role. In this respect, as well as in other aspects of systemic changes, the three East-Central European countries (Hungary, Poland and the Czech and Slovak Federal Republic) have made the greatest progress.[1] In the following study I intend to review the most important issues related to economic opening in Poland and the CSFR, as derived from the experiences of the past 2–3 years. Lessons to be learned from such experiences will be analyzed. Furthermore, I shall attempt to interpret the differences among the Polish, Czechoslovak and Hungarian experiences, and draw conclusions which are relevant for Hungarian economic and foreign trade policies.

Foreign economic liberalization in Poland and the CSFR show many similarities with regard to the basic philosophy—and the character—of applied measures as well as the dynamism and fluctuations of liberalizing and protectionist endeavours. Nevertheless, considerable differences can also be found in the liberalization practices they have applied. The reasons for this can in part be traced back to the differences which characterized the macroeconomic position and internal and external balance relations of the two countries when liberalization measures were first implemented.

Another key difference was that the Polish programme of high-speed, dramatic, "shock therapy" was unprecedented in the economies in transition. Thus, economic policymakers in the CSFR had the opportunity to learn from the Polish experience (in addition to experiences of other countries).

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[1] Excluding the ex-GDR. For brevity's sake, the Czech and Slovak Federal Republic is referred to as the CSFR throughout this study. Antecedents and major problems of foreign trade liberalization in Hungary are discussed in detail by, e.g., *Gács* (1991); Oblath (1991); Édes (1992).

Poland 1990–1992

The Polish economic policy reform programme was spelled out in autumn 1989, after the ambiguous change in the political system. The programme was crafted with the collaboration of western economic experts (e.g., J. *Sachs*[2]) and of international organizations (such as the IMF). The economic programme consisted of two parts: macroeconomic stabilization, and a reform package intended to develop the institutional system and the legal and organizational framework of a market economy. One key aspect of the latter part of the programme was the liberalization of the domestic economy and foreign trade.

The elaboration and implementation of the programme early in 1990 took place in the midst of extraordinary internal and external disequilibria. The slow economic decay of the previous several years dramatically accelerated in 1989. Hyperinflation erupted (prices increased by 636 percent between December 1988 and December 1989); the national currency (zloty) became completely worthless and was forced out of circulation; commodity shortages spread rapidly; and growth of black markets accelerated unchecked. All of this threatened the "official" economy with complete collapse. The country, practically a decade since the first rescheduling, paid only a portion of its debts, and was unable to obtain loans on the international money market. New credits were only extended by western governments and international financial organizations to whom 70 percent of the earlier debts were owed. Gross debts amounted to 40 billion dollars at the end of 1989.

The available instruments of short-term economic stabilization are well-known as they had been tested in practice by several hyperinflation-stricken countries. (*Coricelli and Rocha* 1991; *Halpern* 1991) In Poland, these included: a sharp devaluation of the currency; fixing of the exchange rate; curtailment of money supply; and a sharp reduction of budgetary expenditures.

Parallel with the introduction of stabilization measures, large-scale and rapid economic liberalization also took place. This liberalization, virtually unprecedented on an international scale, included the following steps:

— introduction of internal convertibility of the zloty;

— establishing foreign-trade and other commercial activities as a legal right;

— considerably narrowing the scope—and, in the case of imports, practically eliminating the applicability—of foreign trade licensing (import liberalization);

— withdrawing the vast majority of export and production subsidies;

— (as a result of the foregoing) applying import customs duties as the main instrument of market protection.[3]

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[2] See, e.g., *Lipton and Sachs* (1990).

[3] In addition to customs duties, imports also faced a non value-added type turnover tax applied in Poland. However, since this was imposed also on domestic products, it cannot be considered a market protecting measure aimed at imports.

Foreign trade liberalization was accomplished by the radical liberalization of domestic prices, ending certain subsidies, etc. The whole economic package enjoyed the support of the IMF and of western governments. The former extended a 700 million dollar loan for building up the foreign exchange reserves, and thus to mitigate the expected pressure on the balance of payments. The latter created a one billion dollar stabilization fund to support convertibility of the zloty. In addition, western governments granting credits to Poland (i.e., members of the Paris Club) agreed to reschedule the principal and interest payments due up to March 1991 on Poland's 28 billion dollar outstanding debt.

It was expected that the measures of economic liberalization would stabilize the macroeconomic situation and in the process encourage market-oriented adjustment by enterprises. In this context, liberalization of foreign trade—linked to the introduction of convertibility—was destined to elicit changes in the behaviour of enterprises by the reduction of costs, manifested in the broadened purchasing possibilities. Liberalization also was expected to increase competition on the domestic market, and in the process force companies to become more efficient.

One of the characteristics of Polish economic opening to the world was that termination of the vast majority of quantitative restrictions (QRs) was not connected with a clearly sensible (transitory) raising of customs duties.[4] High (40 percent) duties were imposed on only a few durable consumption goods, based on fiscal considerations. The average level of tariff protection was 10.9 percent. The reason for not raising the average tariff protection might have been that the extraordinary sharp devaluation of the zloty in early 1990 to 9,500 zloty/1 USD (six times the 1989 exchange rate) was intended both to keep the balance of trade in check and to protect the domestic market as minor tariff adjustments were made. Polish officials wanted to fix the (nominal) exchange rate for a period of a few months to serve as nominal anchor and provide a stationary reference point for economic agents who were trying to adjust to shocks in the rapidly changing economic environment. As a result of the setting free of domestic prices, the exchange rate was expected to suffer from strong pressure, and thus it seemed important to officials to build some "reserve" into the initial exchange rate. Looking back, the extent of devaluation was probably exaggerated and very likely became in itself an inflation-inducing factor (*Bruno* 1992).

Regardless of the parameters of the initial exchange rate, it is obvious that in the first half of 1990, devaluation restricted imports and prompted exports to such

[4] International experience with foreign trade liberalization shows that the first liberalizing measure is usually the conversion of QRs into tariffs (which by and large amounts to the same level of protection). It is obvious that in most cases QRs distort resource allocation more than the customs duties which offer a similar degree of protection (*McKinnon* 1991). In addition, in (post-)communist countries the former QRs were applied in an implicit way (Gács 1991). Making the protection transparent by converting QRs into tariffs in itself can justify the fundamental changes in import regulation [this issue is expounded upon in detail by *Nagy* (1991) and Oblath (1991)].

an extent that the balance of convertible trade (and payments) fared much better than was expected. (For main economic developments in East-Central Europe see *Table 1*.) Simultaneously, however, the fall in production exceeded even the most pessimistic forecasts.

Table 1

Selected economic trends in East-Central Europe, 1990-1992

(the same period of the previous year=100.0)

	Hungary			Poland			CSFR		
	1990	1991	1992 I–IIQ[4]	1990	1991	1992 I–IIQ[4]	1990	1991	1992 I–IIQ[4]
GDP	96.7	89.8	92.0	88.4	90.2	–	97.0	84.1	87.0
Industrial output	90.8	78.7	83.4	75.8	88.1	97.0	96.3	88.8	79.8
Unemployment[1] (end of period)	1.6	8.3	10.1	6.1	11.5	12.6	1.0	6.6	5.6
Inflation (CPI)	128.9	135.0	124.0	685.8	170.0	141.0	110.0	158.0	112.0
Balance of trade[2]	+957	−1,464	−40	+2,065	−29	+946	−785	+609	+360
Current account[2]	+127	+267	+657	+668	−1,359	+	−1,100	+357	+900
Balance of the budget[3]	0.0	−4.7	–	+0.5	−3.5	–	+0.7	−1.8	–

[1] as a percent of labour force
[2] trade and other transactions in convertible currencies in million dollars
[3] as a percent of GDP
[4] partly estimates
Source: UN ECE, national statistics, press reports

These developments rendered it possible—indeed, to some extent served as a basis from which—to try to stimulate the flagging domestic economy by *reducing* the level of duties. In summer 1990, duty collection on 1800 products was suspended (among them, those on raw and basic materials). In the case of certain other product groups (such as products of the building material industry, machines and equipment used by small-scale producers, etc.) the tariffs were lowered (*Bak* 1992). The average duty level which was 10.9 percent in the first half of the year, fell to 8.1 percent in the third quarter, and declined by 2.9 percent during the rest of the year (*Jasinski* 1992). Hence, for the whole of 1990, the average tariff was about 7.7 percent. At the beginning of 1991, the reduced tariffs and those for which collection had been suspended amounted to 80 percent of all tariffs.

In the domestic market, increasingly exposed by continually declining tariffs and in real terms appreciating currency, the above-mentioned processes could not be maintained for long. In spring 1991, the government was compelled to devalue the zloty by 17 percent, the first devaluation since the end of 1989. At the same time, the government gave up import regulation using permanently decreasing tariffs. The latter step was stimulated not only by imports increasing at a rate exceeding the growth rate of exports, but also by pressure of domestic producer groups who increasingly felt the effects of growing import competition. Inherent in the decision one also could find an intent to increase budgetary revenues, spurred by the threat of a large deficit. In May 1991, only the agricultural products could assert their protectionist endeavours in customs policy, but by August of the same year a new customs regime was introduced which resulted in both the increase of the average customs level and the restructuring of customs duties. Following the increase in tariffs and restoration of previously suspended connection of duties, the average tariff level had, by the third quarter of the year, exceeded the starting level of 1990 (12.5 vs. 10.9 percent). In the fourth quarter, this figure reached 13.5 percent. In the course of restructuring the tariff system, the duty levels established were roughly proportional to the protected product's stage of processing. This meant that the level of "effective tariff protection" developed evenly, thus providing protection first to the domestic manufacturing industries. In addition, the agrarian sector also gained enhanced protection through the new tariff system. Tariffs imposed on the products of the two broad sectors fluctuated between 10 and 20 percent. Following the changes enacted in August 1991, the dominant tariff was 15 percent. In the early days of 1992, further changes were made to the customs system. These probably were spurred, again, by budgetary considerations. The customs duties on certain food products, household electronic goods and durable consumer goods were raised considerably, while the 5 percent duty previously applicable to the crude oil and natural gas imports was cancelled. On the whole, the average level of protection by customs duties increased further.

While increasing duty-related protectionism could be observed from the middle of 1991, significant changes in exchange rate policy, the other primary regulator of foreign trade flows, were simultaneously underway. In autumn 1991, the government abandoned the exchange rate policy of making periodic adjustments, only one of which was made since the implementation of shock therapy. In its place, a kind of crawling peg mechanism was introduced. Through this system, the zloty is devalued monthly by 1.8 percent against the basket of the most important western currencies. Considering that inflation was still 70 percent in 1991, these adjustments could not stop—but at most only slow down—the real appreciation of Polish currency. In light of the balance of trade, but especially that of the current account, which worsened significantly in 1991, it is no surprise that in February 1992 the government resorted to a severe 12 percent devaluation of the zloty.

Viewing simultaneously the changes in the level of customs protection and in exchange rate policy, it seems that a strengthening protectionism has been evolving. This stands in sharp contrast to the first one-and-a-half years of shock therapy which resulted in a rapid opening of the domestic market. This assessment is reinforced by the fact that beginning in 1992, restrictions and/or obligatory licensing of certain imports again were included among the arsenal of tools used to regulate Polish foreign trade. At the moment, the list of products includes only energy resources and fuels, food articles and passenger cars, but it still represents a regression compared to the earlier system of import regulation (Bak 1992). In the wake of the domestic economy's protracted recession, some policymakers and economic advisers advocate selective measures of export stimulation in an effort to launch an economic upswing. Supporters of such action expect the same result from further protection of the domestic market, by using not only tariffs and QRs, but other economic tools as well. All this is, of course, dependent on the perceived failure (or incomplete success) of the shock therapy, on delayed economic stabilization and on the unexpected longevity of the recession.

Regardless of how Polish foreign trade liberalization develops (as the outcome of actual foreign trade performance; fluctuating power relations among domestic pressure groups, associations of economic interests; and various tendencies in economic policy), it is interesting to examine to what extent the ideas linked to the expected effects of market opening on economic behaviour proved true. Due in part to the short period of time which has transpired, only a few analyses have appeared which have examined the issue empirically. There are certain signs indicating that competition on the domestic market, sharpened in the wake of the market opening, exercised a favourable effect and a power of discipline even on the rather concentrated Polish state-owned enterprise sector. In this sector, extensive privatization and the arrival of foreign direct investment have yet to be seen. According to certain analysts, "the anti-monopoly office, which began to work in 1990, never presented as severe a 'danger' to domestic monopolies, as imported goods did" (Jasinski 1992, p. 9). Initially, domestic market competition became especially lively in the market for consumer articles and investment goods, following import liberalization. It is a separate question whether the transition from a rather autarkic domestic price structure to one approaching the relative world market prices brought about a more effective allocation of resources. Although it still cannot be statistically proved that liberalized trade brought Polish production costs nearer to those in the world market, some Polish economists think it probable that a "convergence of costs" did begin (Jasinski 1992).

The Czech and Slovak Federal Republic (CSFR), 1991–1992

In the CSFR, practically up to the political turnabout in autumn 1989, a very rigid and traditional socialist economic mechanism prevailed. The same can be said about the country's foreign economic regulatory system, which maintained and reinforced the closed character of the economy; its orientation toward eastern (mainly Soviet) selling and purchasing markets; and central control of foreign trade flows. The first fissures in this system appeared in the second half of the 1980s. During these years, retention quotas were introduced; the monopoly position of the large state-owned foreign-trade enterprises was somewhat weakened; etc.

However, potent and systematic changes came to pass only beginning with 1990. These changes fit within the conception of the transformation of the economic system, and took place mainly in 1991. The explanation of this delay is that, on the one hand, development of the reform-scenario for the shift to a market economy was completed only in the second half of 1990, and, on the other hand, the reform-scenario itself also reckoned with a transitional period prior to the introduction of radical foreign and domestic economic liberalization measures. These measures were envisioned as the first phase of reform. Consequently, in 1990 the implementation of a two-tier banking system, crafted during the former regime, was carried out; the monopoly of foreign trade was further loosened; and attempts were made (through price increases, curtailment of subsidies, and devaluation of the currency) to preserve the macroeconomic equilibrium which was traditionally stable in the country. Parallel with these steps, the elaboration of the legal framework conditions for large-scale reform measures planned for 1991 began. Most of the measures implemented in the course of 1990, while practically leaving the core of the centrally planned economy (central allocation of resources, plan targets) intact, (*Hrncir* 1991) aimed at preventing hyperinflation in the initial state of transition. Policymakers intended to introduce institutional and structural reforms under relatively stable economic conditions (in contrast to the Polish and Yugoslav transitions). Economic development in 1990 indicates that they achieved success in this regard. The rate of inflation jumped "only" to 10 percent, from the 1.4 percent stated for 1989. The GDP and industrial output decreased moderately, and the rate of unemployment was just one percent at the end of 1990. The state budget closed with a slight surplus, and the ratio of both budgetary expenditures and subsidies to GDP diminished. It was solely the foreign economy where disequilibrium surfaced. Although at the beginning of 1990, and repeatedly throughout the year, the crown was considerably devalued in relation to the convertible currencies, the balance of trade accounted in convertible currencies closed with a large deficit. In addition, current account deficit rose to more than one billion dollars. Financing the deficit was at the expense of reserves, which declined sharply in 1990. At the end of the year, they were enough to cover imports for just 1.4 months. (In 1989 they covered 3.8 months worth of imports.) The CSFR's gross debt amounted to 8.1 billion dollars at the end of 1990.

Implementation of comprehensive reform measures started early in 1991 under these macroeconomic and institutional conditions. The most important objective of the reforms was a rapid and fundamental change in the routine behaviour and reactions of economic agents (*Hrncir and Klacek* 1991). One of the key points in the reform package—that may be considered a "minimum shock therapy" (*Williamson* 1991a; *Köves* 1992)—was the rapid internal and external liberalization. In the framework of the latter, the comprehensive system of import licensing was terminated, and the administrative regulation of imports was replaced by customs and custom-like instruments. Exchange rate became also considered as an effective instrument to influence trade flows, but only in the last resort. Maintenance of the opening to the world economy was also supported by international financial and other organizations. In January 1991, the IMF approved a 1.8 billion dollar stand-by credit for the CSFR; the EC granted some 670 million; and the World Bank approved 500 million dollars in loans. In the background of the rapid opening up of the economy and the narrowing of the scope of import licensing, a 2.5 billion dollar deficit on the current account was forecast.

By the so-called internal or limited convertibility of the crown, a convertibility category unknown in advanced market economies was adopted. Internal convertibility in the context of the CSFR means that the companies listed in the trade register and considered domestic entities under the Foreign Exchange Act (including private entrepreneurs) may purchase, without limitation and licensing, convertible currency for business transactions related to major items of the current account. Foreign currencies can be purchased from commercial banks entitled to pursue financial transactions linked to foreign trade, at the official exchange rate currently in force. Exporters are obliged to sell the convertible currency receipts of their exports to the above-mentioned banks, at the official exchange rate. Private persons are not affected by these prescriptions and possibilities. They, in accordance with the earlier practice, may open interest-bearing foreign exchange bank accounts for their own use. In addition, they were entitled to purchase, again at the official exchange rate, around 180 dollars in convertible currency (in 1991). During 1992, this amount was raised to approximately 270 dollars. The similarity of CSFR-style internal convertibility and Hungarian import liberalization is striking. In both cases, business organizations with domestic currency may buy the foreign currency needed for current transactions at the official exchange rate, without any special licence. At the same time, they are obliged to convert their foreign currency receipts from exports into domestic currency. A further similarity is that in both countries the vast majority of foreign trade turnover is free from QRs and other administrative limitations.[5]

In addition to the shared practices concerning how domestic currency may be used for foreign economic (business) transactions, the two countries maintain virtually the same policies with regard to who may *not* benefit from convertibility/liberalization and under what conditions. However, Poland's practices related to convertibility differ markedly from those of both the CSFR and Hungary. In Poland, for example, private persons are permitted to buy unlimited quantities of

[5] In particular, this in one of the preconditions of a serious internal convertibility [for details see Williamson (1991b)].

convertible currency at the official exchange rate, a right not accorded in the other two countries.

The arguments made in the CSFR on behalf of introducing internal convertibility and radical import liberalization were the same used in the Polish case, namely:

— the measures taken were expected to increase competition from imported foreign products, thus creating a "disciplining" power over manufacturing and trading companies, many of which enjoyed a monopoly position;

— the "importable" relative prices would allow for rational and efficient price calculations and economic decision-making for domestic economic agents;

— as the result of the above, a more efficient allocation of resources appropriate to a modern open economy would evolve (for more details see Hrncir and Klacek 1991).

As mentioned, the introduction of internal convertibility in the CSFR was preceded by a series of currency devaluations. On the whole, at the beginning of 1991 when economic liberalization began, the crown/dollar rate was almost 100 percent higher (28 crown/USD) than one year before. The thoughts behind this extensive devaluation were similar to the ones held in Poland. Though the (nominal) exchange rate was not declared to be fixed for a longer period (the exchange rate was not declared as nominal anchor), in fact, economic policy-makers intended to maintain it.[6] Thus, the starting exchange-rate level contained a certain "real appreciation reserve" in the CSFR too. This was so, because, as a result of price liberalization and further subsidy withdrawals, a steep rise in the price level was expected in the early months of 1991.[7]

In contrast to Polish import liberalization, however, QRs were converted into tariffs in the CSFR. By early 1991, individual import licensing applied to just 10 percent of imports. QRs survived in just five product groups (arms and other military products; crude oil and natural gas; narcotics and dangerous chemicals; jewels, and precious metals). Along with the elimination of the vast majority of restrictions, however, a 20 percent import surcharge was introduced. Since the country had been a member of the GATT since 1947, the overwhelming majority (96.7 percent) of tariffs were bound and could be modified only in agreement with GATT contracting partners. The level of customs protection was, even by international comparison, extraordinary low. The average, import-weighted tariff was 5 percent in 1988, and 5.3 percent at the outset of the liberalization programme.

Previously, under the centrally planned economy, customs protection held little significance for both economic policy-makers and companies. After the liq-

[6] "The government and central bank declared their intention to maintain the exchange rate, while not committing themselves to any specific period nor excluding the possibility of adjustment" (Hrncir and Klacek 1991, p. 34).

[7] At the beginning, the government reckoned that as a result of the reform measures, the annual inflation rate would increase to 30 percent in 1991.

uidation of the comprehensive system of import licensing, however, the exchange rate policy and duty-like instruments became the main regulators of imports. This is why the import surcharge was introduced—originally envisaged for the period of one year and with approval of the GATT.

At the beginning, with the exception of raw materials, every import item was subject to the 20 percent surcharge. The effect of this was to increase the average level of tariff protection from 5.3 percent to 12.1 percent (***Havrylyshyn*** et al. 1991).

In the first half of 1991 it seemed that with the gradual phase-out of the transitory import limitations, the process of foreign economic opening which began early in the year would continue. In April the rate of the import surcharge was lowered to 18 percent and in June to 15 percent. Semifinished products became exempt from it. Furthermore, the payment-related limitations, enforced in a rather informal way, on purchases made abroad were abolished (OECD 1991). However, the summer of 1991 witnessed a turn in foreign trade regulation. In September nine agricultural product groups again were made subject to QRs. In addition, in the case of the majority of these commodities, the annual quotas were established in such a way that they were practically filled up. This effectively means that a ban on imports was ordered for the rest of the year.

At the end of 1991, a reorganized tariff system—approved by GATT—was adopted. It resulted in significant changes in the order of customs duties and a modest rise in the tariff incidence. The import surcharge promulgated the year before was not terminated, despite the recommendations of experts (Havrylyshyn et al. 1991). However, it was reduced to 10 percent. Early in 1992, the range of product groups subject to import licensing was broadened considerably: coal products, waste materials and some products of the textile and garment industries were added to the list. With respect to food and agricultural goods, as well as to certain steel products, a monitoring system was introduced. This system provides current information on market developments and enables regulatory bodies to take action to restore equilibrium where imbalance arises. In January 1992, the system of countervailing duties was put into force. This simultaneously increased the prices of imports and subsidized the exports of agricultural products.

Despite the fact that market opening was less radical and contained more "transitional" protection mechanisms, the CSFR's course of foreign economic liberalization in 1991 began to resemble Poland's. Liberalization came to a halt, and in certain areas definite signs of retrogression could be seen. Like in Poland, behind the reconstruction of protective walls, changes could be detected, often resulting in protection for the same (producer) interest groups. The heightened level of protection, following temporary liberalization, is noteworthy, as are special interests, sectoral lobbies and pressure seeking for higher tariffs. The changes in the CSFR resulted in a redrawing of the profile of market protection. In one area, the CSFR has not followed the Polish example. Specifically, it did not resort to the global increase of import costs (and export stimulation) through devaluation of the currency. The reason for this is probably related to the shorter interval needed for restoring the macroeconomic (external and internal financial) stability.[8] In particular, in the CSFR, inflation is basically under control. Since the second half of 1991, the rate of monthly price increase has been below two percent, and between February and August, 1992 it did not even reach one percent. On the basis of present financial processes and a determined economic policy, long-term survival of the present exchange rate (even for some years) is likely. A key caveat is that inflation could rise if lasting uncertainty is created as the consequence of the split in the federal state.

An international comparison of the liberalization processes of the CSFR and Poland

The presentation of the foreign economic regulations of the two East-Central European countries examined in this study, and the analysis of the far-reaching changes, which have emerged in the surveyed years, can be instructive in two ways. One way concerns the theories presenting and analysing large numbers of experiences of foreign trade liberalization around the world, and the political recommendations which can be formulated on the basis of them (Köves and Marer 1991).

The majority of experiences linked to economic liberalization come from developing countries working on the basis of more-or-less established market economy mechanisms. *One* of the traits of the East-Central European foreign economic opening is perhaps precisely that it is not "simply" connected with macroeconomic stabilization programmes. Liberalization *cum* stabilization programmes can be found in many developing countries. Liberalization in East-Central Europe, however, also constitutes a part of the much more complex task of transforming the whole economic system.

The authors of a World Bank report thoroughly analyzing liberalization programmes in developing countries summarized the conditions needed for a successful liberalization programme in this way: "The program must be bold and it should start with a bang. If quantitative restrictions are in pace, they should be rapidly dismantled. Where appropriate, the program should begin with a substantial depreciation of the currency. And a stable macroeconomic environment is a *sine qua non*. Almost every program that followed these four simple rules has succeeded" (*Choksi, Michaely and Papageorgiou* 1991, p. 70).

Comparison of the economic structure and institutional system of the countries which have accumulated the most experience regarding attempts at liber-

[8] Which, on the other hand, is, of course the result of the more favourable situation at the outset.

alization with those of the economies in transition, usually leads to a general conclusion. In the case of the economies in transition, it seems as expedient to implement liberalization measures within a shorter time, applying them in larger doses (*Havrylyshyn and Tarr* 1991; Nagy 1991). When beginning the reform, the CSFR liberalization programme generally conformed to the above criteria, while the Polish situation was rather unfavourable, owing to macroeconomic disequilibrium and the consequently high "cost" of creating relative stability. Independent of the differences in the starting conditions, towards the end of the first year of the programme, both countries took steps in the direction of protectionism. In certain areas, the signs of regression have also appeared in the case of Hungarian import liberalization which started on the basis of different antecedents, under more favourable conditions, and evolved more gradually. (Nevertheless, by international comparison Hungarian liberalization has also been radical. See, e.g. Oblath 1992).

Notwithstanding the above, it is necessary to call attention to two facts. One of them is that the East-Central European economies, despite the recent reversions to protectionism, are by international standards very open. In addition, they have opened their markets even wider to products of West European countries, following implementation in March 1992 of the commercial provisions of the association agreements concluded with the EC. Poland and the CSFR concluded similar agreements with EFTA countries, and Hungary is expected to follow suit. In the wake of the radical rearrangement of regional structures of foreign trade, the majority of foreign trade turnover in all three countries is with the advanced market economies, it is hard to overestimate the significance of this fact.

Another noteworthy point is linked to trade patterns. Namely, in the foregoing nothing was said of the dramatic changes in the East-Central European countries' traditional commercial relations, i.e., trade with former CMEA countries, and of the collapse of CMEA markets. This development, however, came about during the period of liberalizing foreign trade in convertible currencies. It is enough to note that in 1991, in all three countries, the *volume* of exports to the (post-)CMEA area fell by about 40 percent as compared to 1990. This external, and to this degree unforeseen shock made the bad recession worse. In such an environment, the need for economic recovery or at least stabilization quite naturally increases the pressure for taking protectionist measures.

Those who advocate a more gradual foreign economic opening, through the use of transitory measures of protection, argue against shock-like import liberalization in two ways. They point out that an initial "over-opening" sooner or later becomes *unsustainable*, thus giving way to protectionist endeavours and the strengthening of market protection. They also call attention to the fact that rapid liberalization cannot be implemented without a significant degree of devaluation. But, beside its inflation-inducing effect, an extensive devaluation leads to stagflation, and in itself contributes to the protraction and deepening of the recession. (See e.g. Oblath 1991; Köves 1992.)

Based on the experiences to date of foreign economic liberalization of the East-Central European countries, it is too early to give a final answer to the questions raised. The construction of the foreign economic regulation system in each of the three countries is still in progress. Hence, we cannot be sure what level of market protection and opening will result. Looking back, it is unclear whether a gradual liberalization could have led to the present level of foreign economic opening (or whether it would have gotten stuck already earlier).[9]

Although it can be argued that rapid import liberalization necessitated a greater devaluation than would have been justified in the case of a more gradual opening, it is not clear what degree of devaluation would have been reasonable in the latter case. Here, the fact must be emphasized that the exchange rate has, in fact, served as a nominal anchor in the two countries examined. Further, it must be taken into account that from the perspective of the foreign trade balance and the balance of payments, the type of foreign economic regulation, the level of liberalization, and the degree of opening, all are of secondary importance in relation to the exchange rate.[10] In other words, from the viewpoint of the development of export-import flows, a certain degree of devaluation cannot be automatically replaced by a definite measure of enhancing protection via customs duties or other methods. Finally, it must be repeatedly stated that in the East-Central European countries, the foreign economic opening represents only a part of the wider programmes of transforming the economic system and stabilizing the economy. The successes or failures achieved in certain elements of these programmes necessarily influence the results of measures taken in other fields.

Experiences of liberalization in the two countries can be summed up in another way, i.e., by looking at Hungarian *trade policy*. Here it is worth calling attention to three points:

— The economies in transition can, with suitable arguments and by proper presentation, obtain the approval of international organizations (GATT, EC) to introducing significant market protecting measures, especially if they are tools found and widely applied in advanced market economies.

— The implementation of the commercial provisions of the association agreements with the EC, the negotiations conducted with EFTA, and the ongoing round of the GATT ***have not hindered the transformation of the tariff system*** (the increase of tariff protection) in the two countries examined. What is more, it may be presumed that one of the objective of restructuring the tariff system was the over-average increase in tariffs of the "sensitive sectors", in anticipation of concessions to be made to the EC during association agreement negotiations.

[9] Slower and more gradual measures may entail the danger that the liberalization programme will fail in its initial stage, owing to the resistance of interest groups adverse to it.

[10] For a more detailed explanation see *Rodrik* (1992).

— While the spectacular increase in duties attracts considerable attention, in both countries a less conspicuous building up of non-tariff protection is in progress. The reaction to this movement (e.g., urging a cessation to the trend) may constitute an important task of foreign economic diplomacy of partner countries, including Hungary.

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MORE DISCIPLINED BUDGET—ADAPTING EDUCATION

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In this paper I want to demonstrate the changes in expenditure on Hungarian education between 1970 and 1990 with the aid of data from the Central Statistical Office, the Ministry of Education, the Ministry of Finance, and adjusted data that rely on the data stock of the former National Planning Office.[1] I will examine how far and in what respect these changes differ from the trends in Western Europe or overseas, and in what way they may be considered typical. Finally, I analyse how education adapted itself to budgetary restrictions in Hungary and in what respect adaptation was similar to, or different from, that experienced in the market economies.

The *published data* on education expenditure does not make it possible to obtain a realistic picture of what has happened to education in recent years. The majority of the aggregate numbers are not comparable in terms of time, the units of observation have changed in the meantime and, in addition, there were even certain items that were registered as being educational, although they can hardly be listed among the costs of education.[2] Hence, owing to the deficiencies of the published data, it seemed right to rectify them.[3] (All the data figuring in the paper concerning Hungary are calculated data, based on the sources marked at the given points.)

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[1] Detailed description of the utilized data and corrections can be found in the study that has served as the basis of this paper (*Varga* 1991)

[2] For a certain time the expenses of Highway Code courses or those of the "Balaton Pioneer-City" between 1988 and 1990 etc. were also included in the expenditures on education.

[3] A rather flagrant "misrepresentation" is worth mentioning. The published data bear relation to the expenditures of educational institutions. The sources are, however, usually not indicated. The expenditures of the institutions are, in turn, calculated as a percentage of the budget. In this way the relative extent of the budgetary expenditure on education is demonstrated. Yet, as can be seen, the source of the institutions' expenditure is not only the budget—what is more, they are using other sources to an increasing extent.

Development of expenditure

In Hungary the proportion of expenditure on education in relation to GDP (and within the budget) increased constantly between 1970 and 1990—albeit at a lower rate than that indicated by published statistics. In contrast, from the late 1970s and early 1980s, in the advanced countries a decreasing share of GDP and/or budgetary expenditures was spent on education (see *Tables 1* and *2*). With regard to the developing countries, it was first of all the strongly indebted Latin American countries that curbed education expenditure.

Table 1

The frequency of growing and declining shares of education within the budget (1972–1982)

Country group	Growth	Decline
Countries with a low income	1	6
Countries with a medium income	6	17
Advanced countries	1	9
Total	8	32

Source: K. M. Levin: *Education in austerity*. UNESCO, 1987.

In general, the decrease in education expenditure came simultaneously in developing and advanced countries, although the causes were different. In both country groups *the endeavours at restricting the budgetary expenditures* played a significant role. However, in the case of the advanced countries it was customary to explain the diminishing ratio of the costs of education by referring to a changing order of priorities and to demographic factors. The generally accepted explanation with regard to developing countries was that expenditure on education reacted rather sensitively to budgetary restrictions.

The philosophy behind expenditure reduction and the techniques used to bring about restrictions were similar in both groups:

— In order to reduce budgetary expenditure, the *individual was expected to bear a greater proportion of the burdens* in education. In most countries this concerned exclusively *higher education*, where attempts were made at transforming the earlier students subsidizing systems, for it was considered that they had been too generous.

The explanation for the unavoidability of increased individual contributions to the burdens of education can, in a broad outline, be summarized in the following. The significant *expansion of education* came into being in the form of a strongly *subsidized free education*. The strongly subsidized expansion of education was supported by the *theory of human capital*. This was built upon ideas concerning the

Table 2

The proportion of education expenditure to the GDP

Continent (country group) country	1975	1986
Africa	4.6	5.9
America	5.9	6.3
Asia	4.3	4.6
Europe	5.7	5.4
Advanced countries	6.0	5.8
Developing countries	3.6	4.0
Argentina	2.5	1.8
Brasil	3.0	3.3[a]
Costa Rica	6.8	5.2
United Kingdom	6.7	5.2[b]
Israel	6.7	10.2[b]
Japan	5.5	5.1[a]
Canada	7.6	7.4
Hungary	*3.8*	*4.5*
Mexico	3.8	2.6[a]
West Germany	5.1	4.6[a]
Norway	7.1	6.9
Peru	3.4	1.72

Source: UNESCO *statistical yearbook*, 1988.
Hungary: computed data
Note: [a]Data of 1985
[b]data of 1984

role education could play in economic growth.

Owing to considerable subsidies, the personal profit of education increased; therefore the inclination to participate in education grew permanently, and hence the *overdemand* for education increased. However, the further increase of expenditure on education came up against budgetary limitations. At the same time, a system of free education could not be built on personal contributions.

The reduction of educational expenditure, almost in all countries, first of all affected *investments*. In the wake of the reduction the share of current expenditure—in relation to investment—increased.

— Within the framework of current expenditure, the share of wages increased. This meant that *material expenditures* were reduced.

— Owing to the extreme labour-intensity of the educational sector, a significant cost reduction could only be brought about with wage reductions and, in fact, a certain effort was made to *reduce the wage costs*. The most frequently applied technique used to achieve this was the reduction of the number of pedagogues, and a shorter working time for the employed teachers. Thus teachers were cheaper to employ and, in some cases, the number of pupils or students per teacher increased.

Though, as we have seen, in Hungary the proportion of the educational expense relative to GDP, and within the budget, not decreased but grew. Yet the growing share, calculated at constant prices, meant an input of decreasing value. Thus, budgetary restrictions, even here, also affected education, and applied cost-reducing solutions. However, *to a certain extent these differed* from the international praxis described so far.

The growth of personal responsibility for costs

Up until recently there was no private schooling in Hungary, and education was in theory free; seemingly the problem of the individual carrying the burdens of education did not emerge at all. There were even political and ideological limits to the bearing of burdens by the individual. In contrast to this, however, in reality, efforts to involve private resources in the financing of education began to appear from the mid-1980s on. As part of this process, in the late 1980s—prior to the elections—a debate started on whether the "basic tasks" of educational institutes should be separated. In other words, should the range of educational services to be guaranteed by the state be defined more exactly? The results of the discussion were inconclusive, and it was not clear in which sphere personal resources would also be involved into financing. However, the data show that a slow rearrangement had started and an increase of the share of non-public sources actually started from the mid-1980s on (see *Table 3*).

Table 3

The division of current costs of education by sources

Year	Public sources	Other sources
1975	92.5	7.5
1980	88.3	11.7
1985	85.9	14.1
1989	83.7	16.3

Source: Computations of the Central Statistical Office for UNESCO statistics.

The ratio of non-budgetary sources between 1971 and 1989 increased from 7.9 to 16.3 percent. In this period of time, the increase was first of all due to the fact that within education expenditure the share of *welfare costs* (daytime homes, students' catering, scholarships, hostels etc.) had increased. Since these expenses depend partly *on contributions*, increase of their proportion also shifted the division of sources in favour of non-public sources. (see *Table 4*).

Table 4

The proportion of welfare costs within education expenditure, according to education levels (in percent)

Year	Primary schools	Secondary schools	Higher education	Education total*
1975	30.9	27.6	7.6	22.6
1980	34.6	28.9	11.2	26.1
1981	34.2	27.9	11.4	26.1
1983	34.4	31.2	27.7	30.9
1984	35.1	30.7	28.0	30.7
1985	34.4	30.1	27.4	30.4
1990	28.5	20.8	23.1	29.6

Source: Calculated data
*Including the data of kindergartens, vocational training and other educational institutes.

Within the total expenditure on education the amounts spent on welfare services increased between 1975 and 1989 from 22.6 to 30.4 percent. In other words, the growth of educational expenditure in the 1980s was caused by rising welfare costs, while the expenditure on strictly educational purposes increased at a lesser rate.

Between 1971 and 1988, *all levels* of education showed a growth of welfare costs that was greater than that of education costs. However, the growth of costs per student with respect to the welfare costs, was greatest in *higher education*.

In secondary education from 1989, and in primary education from 1990 on, expenditure on welfare purposes increased at a lesser rate than that on strictly educational purposes; in high education, however, the welfare expenditure grew faster, and has continued to do so. The growth was partly due to the extension of the sphere of students supported. Namely, the sphere of those obtaining financial subsidies grew from 80 percent to 98.9 by 1990, i.e. the support became all-embracing. If we also take into account that in the same period the share of students coming from non-intellectual families somewhat declined (from 35 to 33 percent), we might at least suspect that some middle-class families were successful in fighting for increasing support for their own consumption costs, via the costs of education.

This process was diametrically opposed to what was happening in Western Europe and overseas. There, in the majority of the countries it was earlier not obligatory to pay tuition fees. In cases where tuition fees were charged, the students received significant budgetary subsidies in order to be able to pay the obligatory tuition fees, and to cover their costs of living. Thus, a reduction in the costs of higher education was achieved by cutting students' subsidies so that *the subsidies could be concentrated on students who are really in need of the.*

Table 5

"Welfare"- and education expenditure per pupil (student) according to education levels (1971–1990)

At current prices, in mill. Ft

Year	Primary level	Secondary level	Higher level
	Welfare expenditure		
1971	1009	1678	2294
1972	1637	2844	2315
1980	2862	4463	6058
1985	4459	6509	20226
1988	6481	7810	26226
1989	8900	8129	34104
	Education expenditure		
1971	2436	4704	26744
1975	3662	7461	31738
1980	5411	10980	47096
1985	9504	15188	53592
1988	13161	18847	76123
1989	20958	27412	111380
1990	28276	39203	156008

1971=100

	Primary level		Secondary level		Higher level	
	wel-fare	educ-ation	wel-fare	educ-ation	wel-fare	educ-ation
1975	162	150	169	139	101	119
1980	284	222	266	233	264	176
1985	442	390	388	323	882	200
1988	642	540	465	401	1143	285
1989	882	860	484	583	1486	416
1990	1118	1116	617	833	2053	584

The *Thatcher government*, for instance, set it as a long-term goal to entirely stop the subsidizing of tuition fees. Though it could not fully reach this aim, the subsidy per student was considerably reduced (between 1981 and 1983 from 900 to 480 pounds). Meanwhile the share of tuition fees within the universities' income grew threefold, (*Policies for* ..., 1983) and the minimum grant – available to all undergraduates – was terminated. In Germany the former subsidizing system was replaced in 1983 by the students' loan system; the loan system is selective and is primarily aimed at those in need of it; also, the amount of credit which can be drawn varies according to parents' income. (*Planning in* ..., 1986). In the United States the ratio of tuition fees within the total of sources for higher educational institutes increased between 1974/1975 and 1983/1984 from 12.8 to 23.4 percent. In private institutions the growth was less: from 35.6 to 38.8 percent. (*Cohn and Geske* 1990). Also, in Latin American countries the earlier systems of support were replaced by widespread student loan systems.

The relation between capital and current spending

In Hungary the share of educational investments within the total expenditure on education in the 1980s was much higher than it was in the advanced countries. Only in the second half of the eighties did it decline (by about 10 percent), which means that it was not investments that were initially affected by the restrictions.

Table 6

The share of educational investments within education expenditure, given as a percentage

Year	proportion of investments
1970	10.1
1975	18.8
1980	19.2
1985	13.0
1989	12.4

Source: Computed data

There are many reasons for this. One of the less important of those is that the investments and current expenditure on education were financed separately. Thus the possibility of direct regrouping was lower, and regrouping came about at a slower rate.

However, a more important reason was that the ever-prevailing growth rate of investments was dependent on the development of the number of pupils, and it was precisely in the late 1970s and early 1980s that the demographic wave reached its peak in primary schools.

Over the past forty years the development of educational investments has been significantly influenced by the number of pupils in primary schools. The explanation for this is that, in primary schools, the shortage of classrooms has been extremely intense from 1950 right up to present. The possibility of adapting to the shortages—other than by investments—is very limited, since, owing to compulsory school attendance, educational management cannot "adapt itself" by postponement or by reference to the lack of classroom space. In addition, other adaptation opportunities have become increasingly impossible—e.g. the possibility of teaching in two shifts declined with the extension of daytime homes.

The shortage of buildings and classrooms has been characteristic of every level of public education. In turn, however, the growth rate of the total of educational investments has been solely influenced by the growth in the number of primary-school pupils, and by the increasing intensity of the shortage in primary schools (Varga 1989). In periods when the number of primary school pupils was growing, increasing the investments seemed unavoidable, and, during the bargaining for the investments, the shortage of classroom space was regarded as a really "irrefutable" argument.

Thus, this is the circumstance which explains why the effects of restrictions only made themselves felt in educational investments in Hungary in the second half of the eighties.

Demographic pressure inevitably weighs heavily on education because in Hungary, over recent decades, the educational network has not been developed by a specific one-and-for-all expenditure campaign. In the advanced countries, simultaneously with the extension of education, over a period of 5 to 10 years, a large-scale educational accumulation was carried out, and educational investments grew considerably for a number of years (see *Table* 7).

Table 7

The share of educational investments within the total of education expenditure (average of the given period, in percent)

	1961–1965	1966–1970	1971–1975	1976–1980	1981–1985
Denmark	13.4	21.9	18.7	12.8	10.2
United Kingdom	23.2	23.2	10.3	7.3	4.2
Netherlands	21.8	20.8	19.5	15.0	
Canada	22.4	18.4	10.1	7.5	7.4
Norway	28.1	27.3	19.1	17.8	15.2
GFR	29.4	23.4	25.2	13.7	10.0
USA	24.1	19.2	16.8	10.9	7.2
Hungary	*13.8*	*15.5*	*17.3*	*19.3*	*15.3*

Source: UNESCO *statistical yearbook*
Hungary: Calculated data

In Hungary, however, this educational accumulation (i.e. the building up of an adequate network of schools), failed to come about. Apart from that, it seems that even in the near future there will be no possibility to rectify this deficit.

Development of wage costs

Wage costs represent 50 percent of education expenditure, and this may be considered low in international comparison. However, from the eighties on, even in Hungary a slight rise of the proportion of wage costs within current expenditure can be observed: between 1980 and 1990 in primary education the ratio of wage costs increased from 42 to 49 percent, in secondary education from 47 to 51 percent, while in higher education it declined (from 47 to 40 percent). The internationally low share of wage costs can also be explained by the high proportion of welfare spending within the total of educational expenditure (namely, the wage costs of this form of education expenditure are relatively low).

In Hungary the budgetary pressure of restriction has not resulted in increasing teacher/student ratios, and also an increase in the proportion of low-wage teachers undergoing a short period of training has not come about. In fact, the opposite has happened (see *Tables 8* and *9*).

The number of teachers employed has increased constantly on almost all education levels. Only in the primary education institutions has a small decline appeared since 1989. The students/teacher ratio has diminished considerably.

Hence, in Hungary the number of students per one teacher in recent decades has, regularly, been *much lower* than it was in the market economies. For instance, in the United States in 1970 in primary schools there were 24.4 pupils per teacher; in 1980 the figure stood at 19. The same indicator in secondary schools was 20.5 in 1970 and 17.1 in 1980. Since that time these ratios have stabilized, or have somewhat increased (*Hanushek* 1986), while in Hungary the decrease has continued.

Table 8

The student/teacher ratio by education levels

Years	Primary schools	Secondary schools	Higher education
1970	17.6	17.3	6.7
1975	15.7	14.7	6.1
1980	15.4	13.1	5.2
1985	14.7	13.1	4.8
1990	12.4	12.7	4.7

Especially noteworthy is the changing composition of the employed teachers according to the time they have been practising as teachers. An ever increasing share is represented by those who have a longer time in full service, while that of the beginner teachers (as well as their numbers) has considerably decreased over the past few years. The most important aim of those already working was job stability.

Table 9

Distribution of teachers employed in primary and secondary schools according to length of service (percent)

Year	1984	1987	1989	1990
1. Leading teacher	0.6	1.9	2.5	2.6
2. Teacher 20–	30.0	31.6	32.2	32.5
3. Teacher 15–20	12.8	14.3	15.8	16.5
4. Teacher 8–15	23.5	25.1	24.8	24.9
5. Teacher 3–8	17.6	16.8	15.6	15.8
6. Teacher 0–3	15.5	10.3	9.1	7.7

Source: 1984–1989, Ministry of Finance

Accordingly, the schools were least sensitive to the development of the teachers' wage costs. Employing "cheap" teachers with little experience was not urged. What is more, the earnings of teachers of the highest and lowest rank order shifted in favour of the former (see *Table 10*). In this table I have pointed out what ratios were characteristic in some countries in 1987. As can be seen, in Hungary in 1987 the earnings' differences of the widest separated teacher groups were greater than elsewhere, and until 1990 the differences continued to increase.

Table 10

The average earnings of primary and secondary school teachers in the lowest and highest rank order, presented as a ratio

	1984	1987	1990
Hungary	1:2.1	1:2.2	1:2.7
USA		1:2.0	
Canada		1:2.8	
Italy		1:1.6	
Netherlands		1:1.5	
Scotland		1:1.6	
Switzerland		1:1.5	

Source: J. Guthrire, W. I. Garms and L. C. Pierce. 1988. School finance and education policy. Prentice Hall p. 271; separate calculation for Hungary.

Parallel with preserving job stability, within the growing number of teachers the share of the relatively more "expensive" teachers increased, while the current budgetary expenditures were cut slightly by restrictions. At the same time the real wages of teachers declined and their relative position compared to that of other occupational groups also became worse (see *Table 11*). However, as we have mentioned, teachers tried to slow down this process behind the "earthwork" of a salary system that was adjusted to service time. Thus the earnings of teachers of a higher rank (generally having longer times of service and greater ability to assert their interests) increased considerably faster than those of the younger ones. In addition, and partly as a result of this, the composition of teaching staffs has shifted towards a situation in which the majority have served for longer periods of time. In the meantime the change in the teacher/student ratio presumably indicates the success of endeavours at reducing the performance, and also signifies a reaction to the worsening position of earnings.

Table 11

Earnings of intellectual workers belonging to material sectors, related to the earnings of primary and secondary school teachers (teachers' earnings = 100)

	1975	1984	1987
Industry	108.5	108.3	123.8
Construction	120.1	114.1	131.5
Trade	98.4	99.7	113.5
Material sectors total	108.0	102.4	120.2

Source: Calculated data

Thus, the data show: the fact that in Hungary, in the 1980s, the educational expenditure could preserve its weight in relation to the GDP and its proportion within the budget. In practice, the main role was played by the welfare- and employment-political objectives. In other words, in the 1970s and 1980s, within the framework of educational affairs—while certain aims of a non-educational type were successfully achieved—the chances of developing an up-to-date, effectively working education system, in many respects, worsened.

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BOOK REVIEWS

FLEMMING, J.-ROLLO, J. M. C. (eds): *Trade, payments, and adjustment in Central and Eastern Europe.* Collected papers presented at an EBRD-sponsored conference held in London on 26-27th March, 1992. London: EBRD-Royal Institute for International Affairs. 1992. 242 p.

The authors of the book investigate the economic perspectives of the central and eastern European region in the light of foreign trade activity, working with the assumption that external trade is considered to be at the core of the renewal of these economies. The papers deal with three main areas:

International trade and payments systems required to sustain intra-regional trade in the eastern bloc;

EC trade policy towards central and eastern Europe; and

Trade policy and long term adjustment in the region.

Intra-regional trade in Central and Eastern Europe

The field of greatest controversy among speakers at the conference was the intra-regional trade in Central and Eastern Europe. There was no doubt that the first and best solution to the problem would be convertibility and free trade; however, the immediate adoption of convertibility could cause unnecessary harm and aggravate the prevalent crisis in several countries. The most serious problem is the lack of foreign exchange. For instance, if the CIS was to adopt a convertible currency, this would cause a fivefold increase in the republics aggregate demand for foreign exchange (*Bofinger and Gros*). Due to the extreme division of labour within the CMEA the collapse of intra-regional trade would accelerate the harmful activities of the recession; nevertheless, this would be economically sound in the long run. Given the degree of specialization and the irrational geographic location of industry, several authors support a payment union as a second best solution (Bofinger and Gros; *Havrylyshyn*). In the short run it could sustain trade at a higher level, avoiding the dramatic fall in output and employment. Disregarding the technical details of its operation, the main arguments in favour of a payment union can be summarized as follows (Havrylyshyn):

— It saves on foreign exchange and therefore encourages sustained trade activity in the short run;

— It adds more credibility to trade operations which are not currently available, given the problems of the rouble as a unit of exchange. The trade union would not be able to handle the serious problem of trade account disequilibria. Therefore, to avoid large and persistent structural deficits a credit mechanism should be set up, with self-restrictions and tight credit ceilings.

— It reduces the number of financial operations needed across new borders by new and underdeveloped banking systems;

— It may, if well designed, encourage quicker elimination of state trading procedures and thereby encourage a quicker transition to commercial trade relations. Long run goals must be borne in mind, and arrangements for the payment union must incorporate a time schedule for switching to convertibility and liberal trade policy. Havrylyshyn believes the medium term (3-5 years) should be long enough to achieve these objectives.

The central European authors argue that rebuilding intra-CMEA trade by creating payments preferences would be a mistake. They consider it necessary to contract from an artificially high level of trade to a normal, sustainable level, involving an adjustment to an economically wise trade pattern. Results of the gravity model of trade presented by *Rosati* support the belief that level of trade flows are not lower that can be considered viable. Factor endowments and their complements do not imply expansion of intra-regional trade. (*Csaba*) The problems that appear during the transition and rebuilding of intra-CMEA trade can never be seen as a remedy; in fact, they only prolong the agony. Collapse of eastern trade was the last factor contributing to the ruin of the firms threatened by structural, organizational and financial difficulties (Csaba). Rosati stresses that these countries are facing two problems of a different nature and thus they require different solutions. The first one is the foreign exchange liquidity crisis—especially in the former Soviet republics—which may eliminate viable trade flows. The second is the need for competitive restructuring of production and trade. The appropriate cure for the first problem cannot eliminate or slow down the results of the second. Possible solutions are payments arrangements that economize on currency use, bilateral or preferably multilateral clearing, and barter. A growing share of intermediate trade and joint ventures could contribute to the maintenance of trade flows. However, in the former Soviet republics the liquidity crisis cannot be overcome without external financial assistance.

Trade policy of the EC towards Central and Eastern Europe

In 1990 the share of the EC in the total export of the three countries referred to as Partners in Transition (PIT), achieved 30 percent; thus the EC became their most important trading partner. Western trade expansion has played a salient role in avoiding economic and social crisis despite the collapse of eastern trade and contraction of domestic demand. Extensive capital imports have been indispensable for bringing about economic growth. Because of insufficient foreign direct investment, only exports can generate the necessary foreign exchange for the import needs. This justifies the importance of foreign trade and EC trade policy in the prospects of the region. *Messerlin* and *Hindley* are concerned about the protectionist trade barriers that impede exports from the PIT countries, and they review the recent trade liberalization process. The most important step in this process is the settlement of Association Agreements. This eases access to EC markets for a large number of items exported from the PIT, although its main effect is to consolidate previous concessions (i.e. the Generalized System of Preferences). Significant tariff reductions are limited to a marginal segment of exports. The main exports comprise sensitive products, and these will still face substantial tariff and non-tariff barriers. Trade liberalization in agricultural products is embryonic and uncertain, and chemicals are treated quite severely by anti-dumping regulations. These four neglected sectors account for 51 percent of Hungarian exports to the OECD markets. In spite of this, the Agreements contributed to the export expansion of the PIT countries. The estimated direct impact of the Agreement in 1991, given a comparison of the indexes of export growth to EC and EFTA markets, is 41 percent and 29 percent, respectively. In the long run it is more important that export quotas, rules of origin, and safeguard provisions annexed to the Agreement do not undermine the positive effects by reversing the trade liberalization and introducing safeguard measures on exports in a wide range of 'unexpected' situations. A considerable risk accompanying the rules of origin is that they may draw back foreign direct investment. Given the small size of the PIT economies, foreign direct investment is likely to occur in export-oriented activities. The relative abundance in labour may be attractive for both the production of labour intensive parts and assembly work. One consequence of the high proportion of imported components in the final products is that they cannot be sufficiently adjusted and processed, and they are not subject to the preferential regulation of the Agreements.

Results of structural adjustment

Hughes and Hare and *Aghion et al* investigate the future possibilities of western export expansion in the context of competitiveness and the long run prospects of the industrial sectors. The setting up of the free trade area will create new trade flows but divert others. Removal of trade restrictions implies a restructuring of trade flows and production. The cost of this necessary adjustment will be concentrated in eastern Europe in the form of a deep recession, fast dispersal and diminution of capital and high unemployment rate. At the same time the costs to western Europe are expected to be negligible, and will concern only a limited number of sectors. Recognizing the asymmetry of adjustment costs Aghion et al suggest a schedule for gradual implementation of trade liberalization and the minimization of damage. In the long run all restrictions would be dismantled. However, in the first stage the countries furthest back in the reform process would be allowed a degree of protection against all other members of the custom union in order to give them time to adjust viable branches. Those ahead of them in the process would offer open access to those behind, while maintaining protection against those ahead. The EC and EFTA at the top would offer free access for every member country. Yet although this proposal may be cost-minimizing at the edge of the scale, it would unquestionably be very costly for the central European countries. In the EC countries the share of eastern imports in their total import figures is almost negligible. However, the opening up of trade for the eastern products would result in severe import competition in the PIT countries, due to the similar structure of production and the same main export sectors in these countries. Following Aghion's plan, central European countries would be worse off than they would be with the Association Agreements.

Hughes and Hare focus their attention on the impact of the settlement of free trade on the structure of production, identifying the competitive advantages of the central European economies. They try to separate the viable and the hopeless sectors in an open environment. To assess the competitiveness of branches they calculate the domestic resource cost of the sector's production. It represents the sector's contribution to GDP measured by world prices. In the light of competitiveness they analyze the processes that have taken place over the last three years of transition. In spite of doubts about reliability of the data and appropriateness of the methods, the results seem to be robust, and beneficial in analyzing recent developments in Hungarian export expansion. The most important conclusions are the following: the falls in manufacturing output experienced over the past 2–3 years have not shifted production in favour of the more competitive sectors of the economies in transition. A shift from domestic to export markets has not in general led to a shift towards the more competitive industries. This was especially true for exports to the European Community, which were typically drawn from sectors that were less competitive than the average. The exports drawn from the most competitive sectors went to less developed countries. This may indicate that central and eastern European economies have difficulty in meeting the quality standards of high income markets. According to the results, reorientation of foreign trade succeeded, but no steps have been made in the direction of restructuring. Assuming that the more competitive sectors will expand in the long run we have to reckon with the fact that most progressive branches tend to be relatively labour intensive. Results from the simulation presented by Hughes and Hare support the opinion of several other authors (Aghion et al; Messerlin): they expect to see a fast decrease of existing capital and therefore they consider foreign direct investments to be at the heart of the recovery. The comparative advantages of the CEEC lie in the relative abundance of unskilled and specially skilled labour, and the gradual expansion of raw material supplies can be expected. The prime condition for realizing potential advantages is fast adaptability of the labour force to western working methods and management.

The picture sketched out by these authors blows away our illusions about the economic prospects for Hungary. Some events confirm this. Foreign direct investments favour phases of production that are labour intensive and at a low technological level. Fast expansion of assembly work in light industry supports this opinion as well. The crucial point here is the technological adaptability of traditional export sectors, like metallurgy, chemistry and agricultural products. Fast reorientation of trade with the west after the collapse of eastern trade is promising, but as we know from Messerlin and Hindley these sectors are facing the most restrictive trade barriers on the western markets.

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*We acknowledge the receipt of the enlisted books. No obligation to review them is involved.
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CONTENTS

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Agriculture, écologie et développement

sous la direction de Marc DUFUMIER

Introduction

Marc DUFUMIER.- Agriculture, écologie et développement

Colonisation agricole et déforestation

Jean Luc PAUL.- Avant les paysans : agriculture et écologie dans une société agraire de Tanzanie.

Hubert COCHET.- Agriculture sur brûlis, élevage extensif et dégradation de l'environnement en Amérique latine.

Désertification au Sahel

Edmond BERNUS, Jean Yves MARCHAL, Yveline PONCET.- Le Sahel oublié.

André MARTY.- La gestion de terroirs et les éleveurs : un outil d'exclusion ou de négociation ?

Agriculture commerciale et dommages écologiques en Asie du Sud-Est

François GRUNEWALD.- Pêche, forêt et agriculture dans un Cambodge à peine sorti de la guerre civile.

Guy TREBUIL.- Agriculture pionnière, révolution verte et dégradation de l'environnement en Thaïlande.

Jean Yves WEIGEL.- Aquaculture littorale et mobilisations environnementales en Thaïlande.

A la recherche de solutions

Pascal Olivier GIROT.- Parcs nationaux et développement rural au Costa Rica : mythes et réalités.

Michel BROCHET.- Les stratégies de lutte contre l'érosion et l'aménagement des bassins versants en Haïti.

NOTES DE LECTURE

Agriculture, écologie et développement par Marc DUFUMIER

BIBLIOGRAPHIE

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CONTENTS

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ECONOMIC POLICY IN CRISIS

B. KÁDÁR

The present state of the Hungarian economy reflects the elements of three overlapping processes, namely, a structural crisis gradually evolving since the turn of the 20th century, an institutional crisis resulting from the distortions of an institutional system forced upon the country after World War II, and, thirdly, those of a transition process started four years ago in the East-Central European region without adequate strategy and external support.

The action programme of a modernisation strategy suitable for the whole nation urges the widespread acceptance of the following equation: no national security can be safeguarded without political stability; political stability cannot be reached without social stability; social stability is not feasible without adequate levels of employment; the adequate level of employment requires economic growth, and, finally, economic growth in the given situation of the Hungarian economy relies almost exclusively upon the strong promotion of the growth of exports.

The morphology of recession

Reasonable economic policy should start out with realistic and feasible objectives. We have no examples of bad judgments of an existing situation resulting in successful economic policy. In recent years Hungarian and foreign theoretical and practical concerns have centered upon the institutional structure of political and economic systemic change. Far less attention has been given to actual economic processes (real sphere), even though it cannot be denied that—once the totalitarian constrains on organic development have been eliminated—it is in this area that success of transformation will be decided.

The stagnation of the Hungarian economy in the 1980s and recession since autumn of 1989 have together caused an almost 20% decrease of GDP, a 35% decrease in investment, a more than 60% decrease in expenditure on R+D, and a 13% loss of jobs. The long duration and severity of the process has induced many people to speak about a crisis situation and seek a corresponding cure. Economic theory and practice are rich in advice about how to treat crisis phenomena issuing from the business cycle. However, the four-year long Hungarian recession cannot be characterized as a classical crisis. The present state of the actual Hungarian economy reflects three interdependent historical processes: the *structural crisis*, which has gradually deepened since the turn of the century and the disintegration of the Monarchy; the *institutional crisis*, which was caused by the distortions of the institutional system forced upon the country after World War II; and the *process of transformation*, which began in the area without a suitable strategy and without outside assistance.

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The dynamic phase of Hungarian economic growth prior to World War I lasted for more than half a century and involved a process of catching-up which was based on the large agricultural, food and engineering markets of the Austro-Hungarian Monarchy. The collapse of these markets, as well as the agricultural and food industry competition from overseas and the subsequent higher level of agricultural self-sufficiency in Europe exhausted the dynamic of this half-century long period progress. The response to this should have been the establishment of a new growth path and specialization at that time (i.e. seventy years ago). However, its absence has brought about a persistent structural crisis, involving a persistent deterioration of the terms of trade, a loss of income and economic progress, and resulted first in lagging behind then being "squeezed out" of the group of countries on a medium level of development. The downward process was aggravated by a totalitarian social-economic model forced on the country after World War II. This model had features of an Asian formation and a distorted path of modernisation which was not harmonised with potential growth endowments. The drawbacks of that system can be listed precisely: inward-looking growth; isolation from the main trends of international development and from commodity and capital markets; inefficient collective forms of ownership; an egalitarian income policy which stifled personal initiative and involvement; and an inefficient but universal system of social services that was established alongside a low level of economic development. The weaknesses of the personal, conceptional, organizational and instrumental components of a decision-making and control all contributed to, at first, the disequilibrium, and then the growth and modernisation crisis of the economy, despite reform steps aimed at cushioning its impact. It is undeniable that, with the "small reforms" of the sixties (a somewhat belated inheritance of 1956), Hungary was the country in the CMEA which went furthest in disentangling itself from the inheritance and distortions of the Stalinist post-Stalinist model. Of all the CMEA countries, it was in Hungary that the legal-institutional framework for a market economy and the institutions of civil society were the strongest. At the same time it was in Hungary that the psychological obstacles to a market economy and a competitive society were the weakest. It is a fact, however, that even the most "marketized" version of real socialism could not adjust successfully to the requirements of global development, scientific-technical revolution, and modernisation of post-industrial society. Systemic change was initiated in Hungary under the curse of a *comprehensive crisis*. (Kádár 1990) "Transformation within crisis" was a particular challenge both from the point of view of economic policy and management.

The East European experiences of the last three years have enriched both economic theory and economic policy with new phenomena. Transformation, which started in a crisis situation, brought to light a new phenomenon: "the crisis of transformation". At present it is still in the sphere of forecasting and logical analysis whether the collapse of the empire and the conflict between the goals of transition to market economy and political pluralism will result in a return to the old system and a special new kind of destabilisation due to the crisis of transformation. The 30–40% decrease in production, the fall in standards of living and the rise of unemployment, alongside the dragging on of the recession could lead to these gloomy scenarios.

Due to historical causes, the most eminent schools of economics were created in the most developed countries. As a result the most developed forms of the theory of crisis deal with phenomena of the business cycle. The problematic of structural crisis was developed by those dealing with developing countries and their modernisation and the process of their catching up. As a result, this area of study has only recently, and with weak ties, become attached to mainstream economics. Over the last quarter of a century the transformation of industrial economies into service, information and technology societies has resulted in the disappearance of traditional industrial activities, the rapid cyclical changes of skills, and the changing international position of individual countries. Yet, over the past fifteen years the attention of economists in those developed market economies has turned to the problems of structural change and structural policy. The crisis of real socialism was conceived first of all as an ideological-political problem, and interestingly enough it was dealt with—during the period of detente (i.e. before its collapse) as an alternative model of development. Looking at this case-history it is no wonder that neither theory nor the practice of economic policy was able to control strategically this transformation amidst crisis, nor was it able to handle the new crisis phenomena which emerged in the meantime. Some fifty years ago—i.e. during and after World War II—both economic theorists and practitioners thought that the transformation of the German and Japanese economies would result in much deeper recession and would require much more time for recovery than actually turned out to be the case. Rapid systemic change and reconstruction in the German and Japanese economies as well as the presumed growth in the equally rapidly implemented Stalinist models in Eastern-Central-Europe caused a real shock among expert economists. As a result of this and the smoothness of South-European systemic changes, the time, cost and pitfalls of the new systemic changes in 1989–90 were given less attention. The euphoria attached to the transition to market economy caused a situation in which the warnings about possible problems were held to be destructive. However, with the appearance of recession phenomena in the process of transition many specialists were suddenly converted to a different approach. For many it became a theorem that recession is unavoidable during transition, and even came to believe that its depth is a signal of the force and success of the process of transition. Seeing the difficulties, those commentators who found themselves in a helpless situation repeated cliches such as: it is easier to make fish soup from an aquarium or omelette from eggs than vice versa.

Such statements did not—and do not—help much. Also, their validity is restricted, since the People's Republic of China has produced a very dynamic change of economic system without changing the political system.

It is worthwhile to look at the past efforts of Hungarian transformation in order to reveal the extent and the nature of the crisis phenomena. Unfortunately we have no reliable statistical data on the extent of the recession. The most significant successes of Hungarian transition have been taking place in the deep layers not assessed by statistics and economic policy: namely, in the still rising shadow economy and in small ventures outside the compass of official statistics. From among all the Eastern and Eastern-Central-European countries it was Hungary where the share of the shadow economy was largest in 1989 (18% of GDP). The sector has grown dynamically ever since, and it is very likely that it has counterbalanced the extent of the recession in the statistically assessed, official sector. A part of the GDP where a decrease has occurred involves non-viable activities; these do not produce, but they do consume national income, where the value of inputs is larger than that of outputs. Neverthess, in this area the decrease of production has not caused a loss of income. In fact, the income-reducing effect of the GDP decrease over the years 1989–92 is probably no more than 10–12%. Yet this is still a recession unheard of since World War II. Its dimensions, however, have not yet reached those of a general crisis. It is not general since it does not embrace small ventures or the service sector. The value of exports is also higher than in 1989, despite the decrease during the first four months of 1993 (a phenomenon unparalleled in the area).

In the case of Hungary one cannot speak about the *crisis of transformation*. The process of transformation has always been going ahead, even if its speed is uneven. We have to take into account that, between the first quarter of 1989 and 1993: the contribution of the private sector to GDP grew from 18% to 45%; the number of self-employed rose from 161 thousand to 630 thousand; the share of liberalized imports increased from 35% to 93%; the share of OECD countries in total exports went up from 38% to 70%; and the ratio of state subsidies to GDP decreased from 19% to 4%. Given these facts we can see the speed and the continuity of economic systemic change. We can say that in Hungary—unlike in other countries—transformation has reached the "point of no return", and social and economic automatism make transformation irreversible.

As a result of the time lags that exist within economic processes the growth performance of 1990 and 1991 reflects basically the inheritance of the institutional and structural crises of past decades. The collapse of the Soviet Union and CMEA and the limited solvency of most Eastern European countries has reduced Hungarian exports to the area by almost 5 billion USD. The total cost to Hungary of the collapse of Yugoslavia is more than half a billion USD. There is a strong connection between the income reduction of the years 1989–91 and the consequences of the crisis of the former system. On top of this foreign trade reorientation, the speed of modernisation was also slowed down by the Iraqui crisis and the recession in the world economy. These factors diverted resources needed for supporting the transition and had an unfavourable influence on the absorption capacity of foreign markets. The outside environment facing the Eastern European transformations has been much less favourable than that which faced German and Japanese reconstruction, or the modernisation programme and systemic change of Southern Europe in the sixties and seventies. It should also be noted that to transform a totalitarian social-economic system into a market economy under democracy is a much larger step than to transform market economies under totalitarian rule into democracies. The majority of transformation problems experienced by the Hungarian economy have been due to exogenous factors. The unavoidable deterioration of the crisis of the former system was endogenised by an economic policy which, rather than concentrating on the ways to counteract the deterioration of the outside environment, paid most attention to changing the institutional system. Thus the transformation of the institutional system was financed to a large extent from resources intended for the future, and at the expense of the accumulation of human and physical capital necessary for exploiting the source of world market competitiveness. The deterioration in Hungary's economic performance, and the slow pace and intensity of changes in the Hungarian production, utilization and foreign trade structures show that the successful achievement of the process of transition, and the elimination of obstructions and constraints preventing Hungary catching up with Europe, depend to a large extent on the ability to surmount the inheritance of decades of structural crisis. This has to be achieved if a new growth path is to be started.

Value and goal orientation, sequencing

Neglect of the deeper lying structural and foreign economy causes of the present social-economic tensions has brought the Hungarian economy and society to a crossroads, despite the undeniable successes of the process of transformation. Although the source of the tensions is definitely the crisis of transformation and not a large-scale classical production crisis, its branch-level repercussions (e.g. agriculture, defence industry, engineering) are often critical and concentrated in particular regions. (Kádár 1991) In a shrinking, struggling economy with a gloomy future privatisation is easily halted. Unlike transnational firms the Hungarian private entrepreneur, who does not have a long-term perspective and has no resources to weather short-term difficulties, cannot shoulder large risks and invest, especially if recession or stagnation are likely. The consequences of recession, coupled with the bankruptcy law enacted in 1992, had by 1993 reached even the successful units of the Hungarian private sector. Recession touched not only the less competitive government sector, but the more dynamic private sector too. A cumulative consequence of this could be that efficient privatisation and changes in the ownership structure will be halted. Similar considerations pertain to a large part of foreign investors too. Stagnation, bad foreign trade performance, and an uncertain future will imperil the continuity of capital imports; also, the world economy upswing expected in 1994, coupled with dynamic modernisation in certain countries, might divert the flow of capital away from Hungary. The perpetuation of gloomy economic perspective in politically sensitive periods might reinforce disintegration phenomena in Hungarian parties, local governments, and pressure groups. This could prompt them to oppose the activity and momentum so vital for successful modernisation.

It goes without saying that systemic change in itself cannot influence structural processes and the business cycle—particularly in the short and medium run. As an example, let us mention that in the opinion of the West the crisis of Soviet society was caused by excessive and pervasive state control. At the same time if the rapid winding up of state control is not accompained by other suitable steps there will be no improvement of macroeconomic processes. In difficult situations it is very important to reveal driving forces, impact mechanisms, and the sequencing of macroeconomic processes. The high social cost of Eastern European and Hungarian transformation has been caused to a large extent by the inverted logic of sequencing. Any population which has possibilities of asserting its own interests wants not simply change in the institutional system and a systemic change, but improvement in its own situation in the foreseeable future. The efficiency of the use of capital cannot be improved merely by distributing state property. Privatisation has to occur in an environment favourable for ventures. Convertibility or an overvalued currency is not the cause but the consequence of healthy economic development. The adaptation of the Hungarian economy to a continuously changing world and European economic space is an indispensable precondition for systemic change which will be appreciated internationally, and rapid modernisation and catching up which will be appreciated domestically.

In the 1930s the theory and practice of macroeconomic control formulated the tools necessary for discarding functional troubles and crises of an industrial society. It is certainly no wonder that Keynes and the New Deal in the English world, Schacht in Germany, and Takahashi in Japan simultaneously applied the revolutionary theses of business cycle policy for the industrial world. The textbook of Keynesian principles most familiar to the Hungarian reader (that of Samuelson and Nordhaus) formulates this as follows: "Keynes proclaimed that unemployment could be a persistent feature of an industrial economy..... Through monetary and fiscal policies government can stimulate the economy back toward high employment, for example, if the government were to increase its purchases, aggregate demand would be increased. In short, by appropriate use of economic policy, government can help to ensure that the economy will move toward a desirable level of output and employment. This theory and the means determined by it may be used in spite of the fact that economists who tend toward the classical view will often be sceptical about the need for government to take steps to stabilize business cycles."

(*Samuelson and Nordhaus* 1989) Although Keynesian economics is not intended for underdevelopment and structural modernisation but for the business cycle policy of a nearly ripe industrial society, its relevance for the dynamisation of the real sphere in today's Central European countries that are on a medium level of development, is much stronger than that of the monetarist stance which relies on mechanism of post-industrial society.

Within the Hungarian economic policy toolkit of the last half decade (i.e. in the period preceding systemic changes) an overwhelming preference has been for tools with a short run impact. In the race between short run and long run requirements, the short run has won. It is interesting to note that from among the "short term tools" of economic policy, automatic stabilizers such as unemployment benefits and other welfare transfers were preponderant in 1992–93. Public works, state employment programmes pertaining to so-called discretionary fiscal policy, and changes in tax rates were not instituted. The importance of this problem is particularly significant if we consider that the deficit of the Hungarian budget (which has existed for several decades) is not transitory but structural, i.e. it originates from the weak income-producing capabilities, being a structural and not conjunctural crisis phenomena. In such a situation it is a basic requirement that the income generating capacity of the economy should be enhanced through investment, technology development, specialization, exports, and rationalization of the state budget. If the structural crisis cannot be eradicated, it is no wonder that a structural budget deficit arises. With a weak or deteriorating income-producing capacity, a budget that leans against the trend of the real sphere of the economy means that an increase in the deficit cannot be avoided. The tensions of transformation, the increasing ex-post deficit and the business cycle reflect the neglect of forces operating in the real economy and the consequences of a balanced 1990 budget. The problem of the budget deficit is not independent from the goal hierarchy of economic policy. The taming of inflation is in the centre of Hungarian economic policy. Taking and overview of the period 1920–1990 in Hungary, inflation is now the highest since World War II, and the third highest since World War I. Thus the taming of inflation is higher on the list of objectives than in countries with a luckier monetary history. At the same time, in presenting inflation as public enemy number one the psychological state of the financial leadership was more crucial than that of the population. After the collapse of the systems of planned and also of socialist market economies in the second half of the eighties a strong "demonstration effect," (i.e. copying) has prevailed in economic policy. Since World War II leading market economies have not experienced deep crisis. The economics literature has paid little attention to non-existent problems and has been busy with disequilibria and inflation. Despite the different state and policy objectives of the Hungarian economy, among economists who are less experienced with growth problems the policy priorities of the post-industrial model have had a strong echo. Thus it has not been stressed enough that the growing disequilibria of the Hungarian economy were caused not by oversized demand but by undersized supply; the latter cannot be cured by demand constraints and the lessons of the Phillips curve.

In the calmer atmosphere of future times one can hopefully analyse in detail to what extent it is rational to reinforce the demand shock generated by the crisis of the socialist system, the collapse of Eastern markets, systemic change, the supply shock generated by the opening to the world market, and import liberalisation (i.e. different exogenous impacts caused by business cycle shocks due to neoclassical fiscal and restrictive monetary policies). Synergic effects might be superimposed in a negative sense too. Introducing an economic policy instrument in itself can be right, for instance, opening to the world economy, liberalization are both inevitable requirements of systemic change. In order to redress the upset of the macroeconomic balance that was experienced in Spring of 1990, it was necessary to use restrictive measures in monetary policy too. Restrictions implemented during three years of transformation were visibly eased in 1992 relative to the former period, but credit offered to the enterprise sphere grew much less than the rate of inflation and the increased credit needs of an economy in transition. Instead of keeping pace with inflation, exchange rate policy has got a re-valuing character, outstanding in international comparison. Monetary restrictions in a shrinking economy aggravate recession and hinder new investments necessary for structural change, profitability and increase of exports. In all countries in which modernisation is slow there is a danger of copying. This danger can only be reduced if we know the state and the special development characteristics of the individual national economies. It is undeniable that the main source of tension in the economy is not overheating of the cycle but a structural crisis and the multilayered process of contraction.

In search of creative economics and a suitable economic policy

Although the principles of transition economies were already outlined three years ago, based upon several decades of experience, perceptions and conjectures of Hungarian economics, the last three years have strongly been dominated by copying theories developed in countries with totally different development levels and problems. To put it in another way: although in the 1990 elections the majority of voters opted for parties brandishing the slogan of "social market economy" (i.e. a mixture of efficiency and social progress), real social and economic processes have in fact shifted towards a 19th century type of liberal market economy. Among the countries of the transforming Eastern and Eastern-Central-European area, the objective of social market economy was formulated and aimed at only in Hungary. It is perhaps not by chance that the costs of transformation have up to now been smallest precisely in Hungary. Economics and economic policy cannot escape the fact that the belated modernisation that took place after World War II never combined the objectives of liberal market economy and political pluralism.

The pursuit of the process of transition and the easing of social-economic tensions both require certain *conceptional corrections*. We have to accept that the process of transition has different rationalities and truths. Goal conflicts do arise between the rationality of the economy and that of politics. Within the magic square of economic policy the truth of the financial sphere requires financial stability and equilibrium; that of the trade unions requires employment; that of the creditors requires a balanced current account; and that of modernisation requires growth. The opposite of truth is not an untruth—as many think—but another truth. The science and art of economic policy lie precisely in the harmonisation of these different requirements and truths—namely, in the proper acknowledgment of the prime requirement of the historical moment. Growth may be pursued at the expense of financial equilibrium, in the same way as financial equilibrium can be pursued at the expense of social and political equilibrium.

Proper value orientation in economic policy can be assisted by taking into account different elements of the actual situation. Past Hungarian and foreign experiences of the region show that in a shrinking economy budgetary deficit, structural arrears and intensifying social tensions are unavoidable. From an international and European point of view the security and stability of the country have a high value. This requires growth and employment. Both national and international interests are therefore attached to a *growth-oriented* economic policy.

Is Hungarian economic growth a mirage or a real possibility? It might be worthwhile to draw attention to the fact that it is the first time since the "interest rate explosion" that international economic policy has put so much stress on the requirement of growth. The economic policy of the Clinton administration, the Japanese expansionary package announced in April, and certain signs coming from the EC all point towards a turnaround in the international environment. The requirement of economic growth is unequivocal from the point of view of the process of transition and modernisation. The picture is not unfavourable with regard to the sources of growth either. With unused production capacities and 13% unemployment the inflationary effect of growth is restricted. Savings at a level of a thousand billion forints, the more than USD 4.5 billion foreign exchange reserve, and foreign capital investment (which is sizable despite threatening forecasts) constitute a sound basis on the part of financial resources and one that has never experienced over recent decades. The main constraints on growth are nowadays macroeconomic regulation, organisation, the social-psychological environment and political support.

"What kind of growth is desirable?"—the question cannot be answered without considering restrictive conditions. Growth and an expansionary cycle were not appropriate in the past nor are they now, a year before the elections (because it would smack of a political opportunist business cycle). This fact might in itself reduce the anti-growth attitude adopted by certain circles, due to domestic policy considerations which herald growth only after 1994—possibly under a new government. We need a type of growth rooted not in the business cycle, but one which deals with the several decades long structural crisis, world market adjustment, and Hungary's catching up with other countries. For those that recognize this it should be plain that Hungarian economic growth depends not on domestic demand, and particularly not on domestic consumer demand. Equally it is not in line with the adjustment requirements of an increasingly globalized world economy, nor is it in the national interests, to engineer growth that relies on a protected domestic market. For more than two decades Hungarian economics has been based on the requirements and objectives of a form of national modernisation that centres upon the characteristics of the country, on boosting supply, and on bringing about structural change; all this has taken place in parallel with the objective of worldwide globalisation and structural adaptation. Despite the strategic lag of two decades, the requirements and objectives are still the same, although the tools and the sequencing of implementation, and techniques used have changed. From the supply side there has been an improvement over the last three years in the choice of foreign capital, technologies, goods and institutional solutions; yet at the same time the supply of domestic investment, R+D expenditure, infrastructure, social-psychological factors and export goods have deteriorated.

The aim of the above train of thought is not a detailed presentation of a modernisation strategy—rather, it hints at some elements of the creative economic ideas that could be relied upon. The current realities of the domestic and foreign situations point to the following: there is no security without political stability, no political stability without social stability, no social stability without an acceptable level of employment, no employment without growth and—in Hungary's case—no growth without exports. The internationally acceptable solution to the Hungarian development equation therefore depends upon *export-oriented growth* and the general improvement of Hungary's ability to compete on the world market.

The solution to the equation might be assisted by eliminating the existing obstacles. Most of the institutional factors that contributed to more than four decades of general deterioration (i.e. it cannot be singled down to any particular area of the economy) of Hungarian competitiveness have already disappeared. The loss of momentum of the successful 1992 export breakthrough might be explained by the lack of goods, the low level of liquidity, the deterioration of profitability and the adverse environment. With a sound diagnosis the therapy is easier to outline.

The severity of the *lack of goods* is demonstrated by the fact that if the markets created by economic diplomacy had been penetrated more thoroughly, and the export dynamic of the first semester of 1992 maintained, the value of Hungarian exports would have grown by USD one billion, and employment by 100 thousand. Although the lack of goods reflects the impact of other bottlenecks too, its immediate cause is the decline of investment, which first became evident in 1979 and which has gained momentum since 1989. The decline of R+D expenditure has hindered the improvement of the product structure, and the development of high value and high price goods. Lack of goods might be overcome by livelier investment activity. In a country like Hungary, which relies on export-oriented foreign trade, this cannot be an isolated measure, for it requires the boosting of both foreign and domestic investment and the continuous development of technology. Structural modernisation cannot be a spontaneous process. Due to the fact that growth faces strong imbalances, the tools of the government cannot include an out-of-equilibrium increase of the money supply. The cure has to be based on tax credits. In this case a choice has to be made between the increase of the budgetary deficit and indirect reinforcement of inflation. Its techniques are well-known: tax reimbursement, recycling of income from privatization, a more flexible amortisation system, government orders, favourable investment financing through special financial institutions, and incentives to foreign capital investment. We have to take into account, however, that a coordinated investment policy will only have an impact on export supply in the medium term (i.e. it is not an immediate panacea).

There are general *tensions in financing*: e.g. low and insufficient financing of exports and export-related guarantees, and the lack of an institution like EXIM-BANK which would couple export credit with export guarantees. These tensions hinder Hungarian exports in finance-intensive goods and relations. This fact is reflected by a strong decrease of Hungarian engineering exports to, and main contractor activities in, developing and Eastern European countries. Its size was USD 500 million in 1992 and USD 300 million in 1993. This has resulted in the disappearance of important capacities and technologies. The low competitiveness of Hungarian exports is due to insufficient guarantees of financing, but this could be improved within a short period by export-promoting credit lines, guarantees and insurance, and also by institutions for bringing these about.

It is an international phenomenon that entrepreneurs go abroad only if *profitability* on exacting foreign markets is higher than at home. The profitability of exports has contracted over the last three years to one quarter of the original figure. In certain sectors profitability has turned into loss, and most sectors in 1992 had, with regard to profitability, gone beyond the point of inflexion. The 25% overvaluation of the forint has had the effect of decreasing profitability over the last three years, and this could not be countervailed with a similar improvement in competitiveness. The exchange rate is a forceful tool of economic policy, for it is viable in the short run and does not contradict international agreements; also, it can boost exports and hold back imports. The effect of exchange rate policy on different actors of the economy is itself differentiated within a heterogenous environment and at the various development levels. Overvaluation has a healthy impact on the national economy with regard to financial stability, sectoral import trade, and production and consumption areas (e.g. energy sector) that rely to a large extent on imports. However, it results in wage-intensive and low import content areas in a decrease of exports and loss of markets. In this case our value orientation has to choose between financial performance and growth—employment—export performance.

The adverse impact of the *economic environment* on competitiveness has multiple effects. A strict implementation of the *bankruptcy law*, which was worked out during a different phase of development and under a different economic environment, has driven a large number of otherwise viable entrepreneurs into crisis; their difficulties have been caused by the bankruptcy of their partners. Suitable selection of partners could bring about improvements even in the short run. For dealing with those exporting firms which face bankruptcy due to the lack of payments from debtors, suitable financial constructions should be introduced, and credit consolidation coupled with reorganisation of banks and regional investment activity should be speeded up. *Budgetary* policy has been shaped in the past such that short-term constraints were placed alongside it. It is undeniable that without fiscal measures that can assist longer term processes in the real sphere of the economy a growth environment cannot be created. In particular, it is the infrastructure and food economy which require schemes of financing and guarantee that are adapted to new European structures. The competitiveness of the economy might be improved by suitable *regulatory techniques*. Flexibility of procedures, sticking to timetables (rapid transfers within the banking and the tax system, increased reliance on tariff disbursement etc.) might improve the efficiency of the economy even in the short run. Over the last three years budgetary constraints have restricted the possibilities of collective export incentives, development of trade infrastructure, and consequently of growth. In the well-functioning Austrian market economy 0.3% of foreign trade receipts are spent on collective export incentives. In the Hungarian market economy, considering exogenous and endogenous policy shocks and the need for exporters to gain access to markets, much higher export incentives are needed. In reality, however, the share of export incentives within foreign trade receipts decreased between 1990 and 1993 from 0.5% to 0.15%—i.e. by one third. Trade agencies and corporate offices that have been closed or down-graded due to financial problems have, up to the present, resulted in the loss of exports to the value of some USD 100 million. This is because a private small entrepreneur cannot enter faraway markets on his own, and the regaining of lost markets is a very costly operation.

We have no example in economic history of such an accumulation of structural, institutional and business cycle problems as those that exist at present. There is no ready solution to be copied, although the danger of copying is high. The science of economic policy is thus confronted with a unique *professional challenge*. The answer should include transformation within the framework of a social market economy, adherence to national characteristics, and adaptation to the world market. The success of economic policy depends on social-political support—i.e. it should be seen to have official backing. Whatever the case, the economics profession should have a creative answer to the challenging problems, independent of the vagaries of politics. The future of the country depends on the quality of, and creativity applied to this answer.

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INSTITUTIONS AND THEIR RESISTANCE TO TRANSITION

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The Central and East-European societies inherited an institutional system characterised by a nearly complete monopolization of the market, total protectionism in foreign trade and a neglect of consumers' interests. One-party rule, state ownership, over-politicization, and supremacy of military consideration in decision-making were dominant factors. Economic agents were not interested in the increase, but in the decrease of efficiency.

The slowness and inadequacy of structural changes are greatly due to institutional rigidity and resilience. They resist competition, opening and the increase of efficiency, authorities resist the diminishing of state intervention. The weakness and instability of political institutions hinder the introduction of radical measures, even when they are recognized necessary.

At the end of 1989 the whole world was surprised at how quickly mass demonstrations, revolts and revolutions caused the collapse of communist one-party rule and the disintegration of the non-competitive, planned economic system in Central and Eastern Europe. There was a widespread feeling of liberation, happiness and euphoria linked to great expectations of political democracy, pluralism and the introduction of an efficient market economy.

However, most observers now agree that over the past two to three years the mood of the population has, equally unexpectedly, deteriorated significantly. A general disillusionment can be observed, and this is because many of the expectations have not been realized. The resistance to change is much stronger than expected, and economic conditions have deteriorated considerably. At the same time disgust with political petty quarrelling has spread rapidly among the populations of these countries.

In both cases, the unexpected nature of the developments was closely related to the lack of understanding of the resilience of institutions; the latter have resisted fundamental change and have made only superficial adaptations in response to attempts at systemic change. The study of the institutional aspects of the transition to a market economy in Central and Eastern Europe has been a very much neglected area in economic theory and in the practice of economic policy. This is the reason why it seems very important to concentrate our attention on such question as: How and why institutions are (were) created? What are their interests and how do they express them? What really motivates institutions? Why are they adaptive but, at the same time, very conservative? Why are they so evidently resilient in changing circumstances? Answers to these and similar questions are obviously very important for the success of transition, but so far they have been inadequate. Western economic theories are very instructive in this respect, especially social or collective choice theory and institutional economics. However, due to the fact

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that Eastern Europe's situation and its history are so different from that of the West, adaptation and application of these theories has to take into account these differences.

Although the collapse of the communist regimes was sudden, there was a long period of decline leading to the widespread and deep social and economic crisis. All the "Kremlinologists", East European experts and comparative economists—without exception—made a great error of judgment: they confused stability with immobility. The immobility of the Soviet-type societies, stubbornly resisting reforms, was regarded by many as stability, when in fact it was a source of self-destructive instability. The more immobile these societies were, the more unstable they became. Symptoms of the growing crisis were well observed by many: misallocation and misuse of resources, low efficiency, lack of competitiveness, slow adaptability, stagnation, deterioration of the living conditions (especially with regard to the environment), shortages of all kinds in parallel with wastefulness and squandering, and a deterioration of worker morale. These symptoms were well recognized not only by outside observers, but within these countries also. Nevertheless, most reform efforts failed, leading to the conspicuous failure of the system.

The resistance to radical, fundamental change meant that immobility, was conserved, and this point is closely related to the institutional structure of communist parties and states in general. The structure of the former "existing socialism" evolved and changed considerably over a period of forty years, but much of this change—in many cases against the wishes of the reformers and planners—went in the wrong direction: instead of curing the sickness of the system, they aggravated them.

One can find a striking contrast, for example, between the first and last decade of the post-war East European economies. The first period was characterized by sudden and extreme nationalizations, rapid industrialization, the expropriation of peasant farmers, and the creation of great estates (the so-called cooperatives). These were followed by relatively fast adaptation to the new conditions. In the last decade, however, rigidity, conservatism, and stubborn resistance to change and adaptation were prevalent. The best example of this was the failure to implement economic reforms, although these were recognized as necessary twenty years before the collapse.

The past: from all-encompassing organisations to special-interest organisations

Following the methods of analysis of M. *Olson* (1965, 1982), this pattern can be explained in terms of the theory of interest groups (see: Nagy 1989; 1991). The Second World War ended with the destruction of anti-democratic, semi-fascist political structures and eliminated most special-interest organizations and other "distributional coalitions" which existed before and during the war. This made possible the coalition of liberal, peasant, social-democratic and communist parties in the semi-democratic conditions of the time. As a consequence the new organizations and institutions which developed shortly after the end of the war had a strong and all-encompassing character, representing not a narrow but a large segment of society.

Time was not enough for the re-emergence of the old interest groups, nor, for the organization of new ones. This was because the communist parties—with Soviet support—soon gained complete control of the East European states. Consequently, the weak or non-existent interest organizations could not resist the introduction of radical structural changes in the society and economy. As time went on a gradual transition could be observed. This was especially noticeable after the popular uprisings and revolts of the mid-fifties during which these regimes preserved their stability in a ruthless manner. Economic and political organizations, state and local bureaucracies and the communist parties themselves evolved into special-interest organizations and collusions; thus they lost their all-encompassing character. Monopolies were created in a historically unprecedented dimension in industry and in services. Through mergers of agricultural cooperatives, large estates came into existence. These were aimed at the elimination of competition, and in this they were successful. A strongly protectionist, autarkic trade policy subsidized both import substitution and exports. Elimination of competition was of course consistent with the interests of industrial, agricultural and service enterprises, as evidenced by the absence of effective resistance to these measures.

These special-interest organizations became powerful lobbies, which did not simply obey central plan directives, but more and more influenced and shaped them. As the various industrial, agricultural and regional lobbies became more numerous and powerful, all of the negative effects so well described by Olson occured. As the distributional struggle among the lobbies increased, more attention was paid to grabbing a larger slice of the pie produced by the society, than making the pie larger. This process involved fighting for funds for unprofitable investments, unjustified military expenditures, lobbying for subsidies, favourable prices, high wages, large bonuses for managers and big Soviet contracts for outdated, low-quality products. The result was that the lobbies not only obtained a larger slice, but in fact reduced the pie—i.e. the GDP—itself.

One of the most influential lobbies that emerged in the Cold War period was the military. Creating war hysteria by constantly referring to the danger of Western aggression, it wasted enormous amounts of resources and was successful in obtaining a large share of the national product and creating a huge privileged sector of the economy, where economic efficiency could be completely neglected.

As the original hierarchical structure of the socialist economies evolved into this complex network of interest groups (a coalition of fighting "feudal" or "war lords"—as some called them), the task of the central authorities became more and more to reach compromises among the representatives of squabbling regional and branch lobbies. The result of this distributional struggle showed their relative power: the well-organized military lobby usually received first priority on resources; mining and heavy industry came second; and a certain pecking order ran through the other sectors. In this struggle education, health care and environmental concerns got what was left by the others.

The inherited institutional system

The Central and East European societies have inherited an institutional system which merits review:

1. *There was an almost complete monopolization of the market and total protectionism in foreign trade.* In state socialism the political monopoly of the communist party eliminated all competitors from political, economic, social and cultural power, and no institutions could exist which were not dominated by the party. Competition was excluded not only in such natural monopolies as oil or aluminium production, but in potentially competitive markets as well. Even butchers' shops and confectionery stores belonged to trusts that monopolized these markets. Foreign trade was completely under state monopoly, and quantitative restrictions, through the licensing system, had effective control over all imports. The aim of monopolization and protectionism was the complete elimination of competition, as it was regarded not only as harmful for planning, but also wasteful. The cultural monopoly of Marxism created an economic culture hostile to liberal economics. Practice proved the opposite of Marxist theory: the elimination of competition served only the interests of inefficient producers, and made them inefficient if they had not been so before.

2. *Consumers' interests were neglected.* Without competition, the producer may completely disregard the demands of the consumer. Under the conditions of an economy of shortage (*Kornai* 1980), a sellers' market prevails, which further strengthens the position of the producer. The symptoms are well known: queues, poor quality, little variety in goods, and empty shelves. Consumers had no influential organizations to defend their interests against producers, and had very little impact on legislation and on other regulations. The producer's lobbies had such an overwhelming superiority that the conflicts of interests were always solved at the expense of the consumers. Consumers look for good quality products in great variety and at low prices; however, producers' interests are just the opposite: high prices, if possible low quality and a small variety of products. When free markets are eliminated the conflict between consumers' and producers' interests is resolved by politics. In this conflict the more easily organized producers have the upper hand, as recognized by collective choice theory.

3. *One-party rule, state ownership, over-politicization (of civil society), and supremacy of military consideration in decision-making were dominant factors.* An overwhelming majority of all property belonged to the state: natural resources, capital, land, schools, theatres, hospitals—everything! There is much discussion in the literature concerning the actual meaning of state ownership: was the state a real owner? What kind of an owner was it? One can say that the state was a bad and a good owner of capital at the same time. It was a bad owner because most of its possessions were misallocated, misused, and insufficiently safeguarded. On the other hand, it was a good owner because it protected the interests of its enterprises in a very effective way: by the elimination of both domestic and international competition. This feature of state ownership was obviously harmful for the consumers, for growth, and for modernization, but it amply served the short-term interests of the producers' lobbies. The consequence of one-party rule, Soviet dominance, over-politicization and over-militarization was that political and security considerations dominated all decisions. Politicians, the military and the secret police were above the law. Arbitrariness ruled, and criticism was silenced.

4. *Inefficiency was a strong pressure.* One of the most harmful features of the inherited institutional structure was that the great majority of the economic agents and organizations were not interested in the increase, but in the decrease of efficiency. As this was recognized, a reform activity developed with the major—and in many cases naive—aim of increasing efficiency. It was evident that for this purpose decentralization was necessary. However, with the growing influence of the special-interest organizations economic reforms became in a sense a liberation movement of the enterprises from the tutelage of the central authorities. However, their demands were rather ambiguous: they wanted to have as much independence as possible, but at the same time they did not want to lose their monopolistic position and their protection from foreign competition. As a result, the half-hearted reform measures that were enacted did not increase growth and efficiency, nor did they improve living conditions; thus they weakened the popularity of the reformers. One should not forget that a certain kind of efficiency pressure existed in the hierarchical planning system: the central authorities demanded larger outputs and offered lower inputs than the enterprises respectively offered and demanded. If the pressure and discipline of the plan targets had been eliminated, as the large enterprises desired, the result would have been even lower efficiency, unless the stronger pressures of competitive markets are introduced. The optimal solution for monopolies can be the worst solution for consumers and for economic growth, as was shown by the stagnation of Eastern Europe in the last period before the collapse.

Resistance to change

The remarkable slowness and inadequacy of structural changes in Central and Eastern Europe are not only the consequences of the failures and inexperiences of the new governments' economic policies, for they are also in great part due to the rigidity and resilience of institutions. The fact that they have been able to resist change to such an extent is largely due to the relatively smooth, peaceful, non-revolutionary character of the changes. One of the consequences of this is that most special-interest organizations and their distributional coalitions have not been eliminated. However, they have become weaker and more hesitant in their lobbying activity.

Yet the new situation has not stopped them building up a strong resistance to change. The main fields of this resistance are the following:

a) *Resistance to competition and to openness.* It was relatively easy to eliminate competition and to create monopolies, but it is extremely difficult to break them up and to "create" competition. Even if they are broken up administratively, the firms that previously comprised the monopoly can still engage easily in collusion, which is difficult to control and stop. Foreign direct investments have not been helpful in many instances, as investment in these monopolies is often considered more profitable than establishing new competing firms. Fortunately, due to international agreements and obligations, it is difficult for the new governments formally to resist explicit trade liberalization. However, with the support of the big lobbies behind them they learn how to build non-tariff barriers and how to keep tariff levels high. Another cause of resistance to openness comes from the fact that the desire for increased inflow of foreign capital through the so-called "selling out" of national property conflicts with the aim of "creating" a new national middle class through distributing (or selling at discount prices) shares of state-owned enterprises to the public.

b) *Resistance to diminished state intervention.* Even at the time of the early reforms of the sixties in Eastern Europe it was recognized that the reduction of state interference in economic decisions was a priority—hence the efforts to decentralize. It was widely expected that with the introduction of a market economy and a democratic system interventions and regulations by government in economic matters would be strongly reduced and rapid decentralization and privatization would ensue. Here again, actual changes have been contrary to expectations: there has been no significant decrease in the budget share of the GDP, the extremely heavy tax burden has not diminished, and the budget deficit has reached unheard-of proportions. Even though there is general agreement that bureaucratization in the socialist system reached incredible proportions, since the introduction of the new order state offices have not closed but have merely changed names, and while the unemployment-rate is high, there is none among civil servants.

Contrary to expectations, privatization has increased the power and prestige of the state authorities: they decide what assets to sell, at what prices and conditions, and to whom. They "create" the new bourgeoisie, which provides great opportunities for political discrimination and for corruption. The structural change in production, the reorientation of trade (especially because of the collapse of East Bloc trade), the unbalanced budget, the enormous debt burden, inflation—all call for central regulation and intervention, which instead of diminishing, has in many cases increased. Moreover, the "dirigiste" ideas of state socialism have not disappeared and the belief that only a strategic state development (or industrial) policy can orientate investments in the right directions is still popular in government offices.

There is a strong resistance to demilitarization and to the abolition of the secret police. An unexpectedly strong nationalistic hostility has broken out in nearly all these countries since the collapse of the old regime. Chauvinistic jingoism seems to be the last refuge of the extreme left, joining the extreme right. In the power vacuum created by the collapse of the previous security system, the military and police lobby have succeeded in influencing government policies by creating and augmenting the instability of the region. Secret services were not dissolved, and their archives were neither disclosed, nor abolished. On whose behalf the secret services will use their "skill" and documents remains an open question.

c) *Resistance to efficiency pressures.* Those with an interest in improving efficiency are weak and unorganized, while forces with vested interests in resisting any efficiency improvement are relatively strong and well-organized. It is a hard task both for the managers and for the workers to change the production structure, technological processes, product quality, or orientation toward markets. It is especially hard to raise productivity, to decrease "featherbedding", and to reeducate the personnel—this is true despite the fact that the trade unions and other professional organizations have articulated interests rather weakly. The reduction or abolition of subsidies and other forms of protection from foreign competition is very uncomfortable, especially if a firm benefitted from them for decades. All these hardships could be overcome if the interest groups supporting improvement of efficiency and adaptation were sufficiently strong and organized. The problem is that this is unfortunately not the case. Privatization, which is proceeding very slowly, has not yet created enough pressure to reduce inefficiencies within firms. The moral, rational, or theoretical arguments for efficiency-enhancing measures are not sufficient to prevail against the power of the strong interests opposing them.

d) *The weakness and instability of political institutions.* A fourth factor hindering change is not a resistance to it, but involves the weakness and instability of political institutions, which prevents the introduction of radical measures, even when they are recognized as necessary. The political situation in all the East European countries is still unstable and the power struggle is undecided. The conflict between the nationalistic right-wing and the liberal democratic parties is strong, and ex-communists have conserved important political and economic positions in several East European countries. The democratic institutions are new and in political practice there are no generally accepted "rules of the game". While the politicians squabble and jockey for power, the fundamental problems of economic transformation are being neglected. Popular support for the new political parties is weak and volatile, hence election results are misleading. The growing disappointment leads to discontent, alienation, and disgust with politics. These feelings are exacerbated by the lack of economic improvement, which further reduces the feasibility of radical measures.

Another consequence of the political instability is that individual rights, including property rights, are not secure. Economic agents cannot be sure that their assets are safe, and it cannot be guaranteed that the contracts they have with other agents will be impartially enforced. The legal framework of limited liability corporations, of borrowing and lending, of patents and copyrights are new and deficient, and there is little experience in their functioning. In such insecure conditions maffia-like organizations grow easily, increasing the instability, and limiting the incentives to save and to invest, and thus limiting economic growth.

Concluding remarks

The Central and East European countries are paying a high price for the non-violent democratic character of the transition process. As there has been little change in the institutional structure and in the network of organizations, their systems can be changed only gradually and with great difficulty, because they have preserved a strong capacity to resist fundamental changes. Olson (1982, p. 75) explained the "economic miracles" of Japan and West Germany with the argument that "countries whose distributional coalitions have been emasculated or abolished by a totalitarian government or foreign occupation should grow relatively quickly after a free and stable legal order is established". If Olson is correct it is no wonder that without the emasculation of the special-interest organizations and their institutional system, in a free, but unstable order, rapid growth is not occurring in Central and Eastern Europe.

It is evident, as argued above, that large-scale and radical changes are needed in all spheres of society to abolish the old institutional structure and to restrict the influence of lobbies and other special-interest groups. However, it is not evident where and how to find the necessary social and political forces needed to implement such changes. Experience to date, although sparse, seems to suggest that neither political pluralism and conflicting parties (as in Hungary), nor a dominating party (as in Rumania and at the beginning in Poland and in Czechoslovakia) can solve this problem. It is not sure either that "great coalitions", advised by some experts, can do this job.

As the opportunity to emasculate many special-interest organizations and their coalitions was missed, there is likely to be a relatively long period of coexistence with the old institutions and change will be guarded. It can be expected that liberalization of trade and capital movements, deregulation, privatization, and the establishment of new small and medium-scale enterprises will, step-by-step, change the economic environment, and the institutions will have to adapt to it. A crucial factor in this development is how far state intervention in economic life can be limited; in other words, to what extent and how quickly the authorities will understand that allocative efficiency is not their business. Instead of supporting inefficient monopolies and conserving privileges, they have a lot to do to defend the consumers, prohibit limitations on competition, facilitate entry of new firms into the market, to secure property rights, and to enforce contracts.

It is too early perhaps for social scientists to evaluate the results of the different approaches economic policy-makers have chosen in the different Central and East European countries. Future development will depend, to a great extent, on how their privatization processes will be linked to the destruction of monopolistic organizations, to the establishment of competitive markets, and the emergence of new efficient business organizations. This development cannot be judged by the ambitions and declarations of decision-makers, but only by the results of their decisions, which remain to be seen.

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THE SOFT BUDGET CONSTRAINT IN THE TRANSITION ECONOMY AND THE PROSPECT OF PRIVATIZATION

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The planned economies of Eastern Europe were characterized by a lack of market discipline in that firms were able to extract various kinds of subsidization in order to produce according to the plan. In this paper it is argued that this phenomenon is likely to be carried into the transition economy. The paper sets up a simple one-period model in which a firm sets wages and employment and the government pays subsidies. The possibility appears that the government must pay excessive subsidies without being able to influence the employment significantly. One way to limit the payment of subsidies might be privatization of the state-owned enterprises; however, this carries the risk that the government's ability to stabilize employment might be reduced.

1. Introduction

The countries of East and Central Europe have undertaken remarkable reforms over the past three years. These *transition economies* are attempting to reform their planned "socialist" economies in the direction of mixed capitalist economies, cf. *Blanchard et al.* (1991).

The East European countries have freed the price setting, and internal and external trade have been liberalized. In most of the countries *small privatization* has taken place, implying the sale of small retail outlets and service sector enterprises to private owners. The *large privatization*—of large manufacturing firms—has had problems in taking off. It is difficult to estimate the value of firms and a quick sale of a firm favours the wrong people. Thus, there are technical and ethical problems associated with a fast privatization of the large state-owned industries. These problems lead to a consideration of whether it is appropriate to keep the large manufacturing firms state-owned for a prolonged period of time. The answer to this question is likely to depend on the government's ability to restrain the payment of subsidies and the provision of cheap credit to troubled firms.

To large parts of the manufacturing sector "state-ownership" implies that the government must subsidize firms in various ways in order to keep them producing. If firms know that they will be bailed out they have little incentive to restrain wage growth and other expenditures. Thus, the government risks excessive subsidization and this might eventually constitute a burden hampering the growth perspectives of the transition economies.

These problems of excessive subsidization of the state-owned enterprises have led to a renewed interest in the emergence of the soft budget constraint: see *Tirole*

(1991), *Berg and Blanchard* (1992) and *Blanchard* (1992). This paper seeks the simplest possible modelling of a soft budget constraint in a transition economy.

Section 2 is used for a short discussion of the concept of a soft budget constraint. In *Section 3* a model for the firm in the transition economy is proposed. We set up a one-period game between a firm and the government in *Section 4* and find the discretionary equilibrium in *Section 5*. *Section 6* examines whether a government can improve its situation if it announces a credible subsidy policy. *Section 7* discusses the possible implications if a firm is privatized and *Section 8* gives conclusions.

2. The soft budget constraint

The market economy

In a market economy the private firm operates subject to a *hard budget constraint*. This implies that the managers of private enterprises seek to maximize profits or, at least, avoid losses. There are several mechanisms supporting the endorsement of the hard budget constraint; cf. Tirole (1991):

— The managers might be paid performance-based incentives.

— The performance of the firm might be compared to the results of similar firms and, hence, the managers are continuously informed of the need for restructuring.

— The firm might be taken over, and the managers will be replaced if their performance is considered unsatisfactory.

— The managers are concerned about their careers. Good results make it easier to climb the corporate ladder in the future.

— The most important mechanism, however, enforcing the hard budget constraint is the *exit constraint*. The loss making firm cannot exist for a prolonged period of time. If the economy of the private firm deteriorates, the owners (the share holders) will intervene and require restructuring and cost-saving measures. If this does not suffice the firm will eventually be declared bankrupt and closed; the exit constraint forces unprofitable firms to close.

The planned economy

In the planned economy the micro foundation of a firm is different from that of a private firm in a capitalist economy. The planner sets quantitative targets for the production and it is practically impossible to declare a firm bankrupt. Deficits will be covered to avoid shortfalls in plan targets and the sacking of workers. When the firm is unprofitable it is frequently possible to extract some kind of subsidy; the firm faces a *soft budget constraint.* (Kornai 1979; 1989) It can appear in many ways:

— The output prices are increased or the input prices are lowered.
— The firm postpones or abolishes the payment of taxes.
— The firm receives soft credit (from other firms or state-owned banks).
— The government pays subsidies directly to the firm.

Naturally, the soft budget constraint implies incentive problems as the management and the workers have little incentive to work efficiently. They know that the firm is always bailed out. This inappropriate incentive structure has been a problem in most socialist economies, and the planners have tried many productivity improving schemes.[1] The soft budget constraint might also lead the firm to use other inputs inefficiently,[2] not just the labour input.

The transition economy

The majority of the firms in the transition economy are still state-owned but it is a nominal ownership, and the management of the firm is effectively undertaken by the employees. The workers typically elect the management of the firm, and it must be assumed that the management will be sacked if it makes decisions that are against the interests of the workers. This type of ownership is labelled by Tirole (1991) "employee management under absentee state ownership".

As the firms in the transition economy are state-owned it might still be possible to extract subsidies from the government. Prices are determined by the market but it might still be possible to receive cheap credit, tax credits or direct subsidies. Thus, the possibility of a soft budget constraint in the transition economy exists.

One argument for supporting the state-owned firms in the transition period is the concern over employment levels. Tirole (1991) points out that the government has an incentive to bail out ailing firms and banks in order to maintain employment levels and writes further (p. 237): "*...there is an important risk that the government be captured by the firms' employees. Labor hoarding is likely to remain, and wages to be way above market wages*".

This concern seems to be well-founded. Most of the transition economies in Eastern Europe seem to have experienced the emergence of a soft budget constraint. The experience of Poland in 1991 is well documented. The Polish firms only received

[1] Examples that can be mentioned are: excessive use of piece-rate systems, bonuses, grants for hard work, or even designation as a "Stakhanov worker"; for examples from the former USSR, see *Kirsch* (1972).

[2] *Gomulka* (1986) argues that the soft budget constraint might induce inefficiencies in the socialist economies but will not lead to a breakdown of the production.

small direct subsidies from the government but built up significant arrays of taxes that should have been paid during the year but remained unpaid. Likewise, the provision of cheap credit made it possible for the firms to pay higher wages than would otherwise have been possible: see Berg and Blanchard (1992), Blanchard (1992), *Pinto et al.* (1992), *The Economist* (1992). More recently, the problems of the former Soviet Union seem to be linked to the provision of cheap credits to the state-owned enterprises.

In the remainder of this paper we shall model a simple game for the transition economy in which the soft budget constraint emerges as a result of the government's concern for the employment situation.

3. The firm in the transition economy

A model for the "typical" firm in the transition economy is set up as a microfoundation. This is because the firm is developed with stress being put on the incentive structure that is part of the ownership organization in the transition economy (cf. the final subsection of *Section 2*).

The firm is nominally owned by the government but it is effectively managed by the workers' council (henceforth often called "the union"). The workers are free to carry out all major decisions, including the determination of prices, wages and employment. Therefore, in many ways the firm in the transition economy resembles a labour-managed firm in a capitalist economy. This modelling of the firm in the transition economy relies on the literature regarding labour managed firms, as well as on models for wage setting in unionized firms.

For the purpose of this paper it is assumed that the union sets wages so as to maximize the utility of the collective work force, whereas the management is reduced to a body which sets prices and employment so that the budget constraint of the firm can be satisfied. This follows the modelling of the labour managed firm, in which the workers maximize a common utility function subject to a zero profit constraint: see e.g. *Meade* (1972). The firm's budget constraint denotes the trade-off between employment and wages. The workers face this trade-off and maximize the utility of employment and wages subject to this. In this sense the modelling of the firm in the transition economy resembles the idea behind the "monopoly union model": see e.g. *Oswald* (1985).

The modelling of the firm in the transition economy differs from the firm in the "market socialist" economy as the price and wage setting in the transition economy is, in reality as well as in principle, left to the firm's discretion. Furthermore, it differs from a firm in a capitalist economy due to the fact that no profit maximization takes place.

The firm produces one output, $Y \geq 0$, using only labour, $L \geq 0$, as its input. The production function is simple; there are constant returns to scale:

$$Y = L \tag{1}$$

A large proportion of the firms in the socialist economy were monopolists. Therefore, its is assumed that the firm in the transition economy is a monopolistic supplier of output Y, and it faces a linear, decreasing demand curve:

$$P = 2 - Y + \epsilon \tag{2}$$

ϵ is an exogenous *demand shock*. The economic environment of the transition economy is very noisy because of the fundamental change of the microeconomic and macroeconomic structure of the economy. Thus the individual firm faces very uncertain demand in the transition period. It is assumed that the expectation of ϵ is zero, $E[\epsilon] = 0$, and the variance σ^2 is constant and finite.

The profit of the firm, Π, is:

$$\Pi = PY - WL \tag{3}$$

where W is the wage paid to the workers. (3) can be rewritten as:

$$\Pi = (2 - L + \epsilon)L - WL \tag{4}$$

Following the literature for the labour managed firm, in the following it is assumed that the union maximizes its expected utility subject to the condition that *the firm does not yield profit*. When the profit is zero, (4) takes the form:

$$(2 - L + \epsilon)L - WL = 0 \tag{5}$$

(5) is the firm's zero-profit (ZP) constraint and denotes (the boundary of) the combinations of wages and employment that can be attained by the workers. Hence, besides being the firm's ZP-constraint, (5) functions effectively as the labour demand of the firm.

Now, consider the objective of the firm. Traditionally, the literature regarding the labour managed firm has assumed that the remuneration to the individual worker is maximized, subject to a zero-profit constraint. This approach does not take into account the fact that the workers might be concerned about the employment consequences of their wage policy. Instead we assume that the union cares about wages and employment and that the utility is a positive function of both. To ease the calculations a specific utility function for the union is applied; the union's utility equals the wage-bill:[3]

$$U = WL \tag{6}$$

It is assumed that the union cannot observe the stock when it moves, although it knows the statistical properties of the shock. The union's problem is to pick the wage which maximizes its expected utility, subject to the fact that the employment is given by the ZP-constraint (5):

$$\begin{gathered} \text{Max } E[WL] \\ \text{s.t. } (2 - L + \epsilon)L - WL = 0 \end{gathered} \tag{7}$$

The solution to this problem is:

$$W = 1 \tag{8}$$

$$L = 1 + \epsilon \tag{9}$$

The wage is independent of the shock. This is a result of the imposed informational asymmetry; the union cannot observe the shock when it sets wages. Thus, employment fully absorbs the fluctuations in demand. The expected employment is $E[L] = 1$ and, henceforth, it is labelled "natural employment".

4. The interaction between the firm and the government

This section deals with the interaction between the two players, viz. the union facing the ZP-constraint from *Section* 3, and the government.[4] It is assumed that the government pays subsidies to the firm in order to bail it out and, eventually, to maintain high employment. In "real life" the government can bail out ailing firms in many ways, e.g. direct payment of subsidies, provision of soft credit, or acceptance of delayed tax payments from the firms. In the model it is assumed that

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[3] This utility function for a labour managed firm is also proposed in *Kreps* (1990), section 19.2. *Frydmann and Wellisz* (1991) examined a number of Polish firms during 1990 and concluded that the firms maximized revenue. Maximizing the wage-bill subject to a ZP-constraint has the effect of maximizing total revenue. Also, Berg and Blanchard (1992) conclude that the state-owned Polish firms maximize revenue.

[4] This game is a modified version of the game in *Commander et al.* (1991). The game was also inspired by *Driffill* (1985), as well as the "standard" monetary policy games such as the one in *Barro and Gordon* (1983). See *Schaffer* (1989) for a game-theoretic analysis of the incentive problems associated with the soft budget constraint in the socialist economy.

the softness emerges as payment of subsidies. The important assumption is that the government dislikes the softness because it moves resources away from other activities in the economy.

The game possesses "extrinsic uncertainty" because the information is incomplete. The union does not observe the realization of the shock when it moves. The government, however, observes the shock and subsidizes the firm that has to take into account the realization of the shock.

The validity of this assumption with respect to informational asymmetry can be questioned. The basic argument is that the wages of the transition firm are fixed prior to the realization of the shock, whereas the government reacts when the shock has occurred. The government might have better information on the macroeconomic condition of the economy and it is most likely that it has better information on its future monetary and fiscal policies. The information assumption is necessary in order for the government to be able to carry out stabilization policies.

Only one-shot games are considered. The general argument is that the players are myopic and, hence, do not take into account the future consequences of their current play. The transition economy is a very uncertain environment and, therefore, the time horizons of the players tend to shorten. This assumption seems to be broadly in line with the findings for Poland: see Blanchard (1992) and Pinto et al. (1992).

The union

The government subsidizes the firm by paying direct subsidies, S, to the firm. The problem of the union differs from the one in section 3 as the ZP-constraint now includes the possibility of the government paying subsidies to the firm. The subsidies paid come to the total S, so the firm's ZP-constraint can be written as:

$$(2 - L + \epsilon)L - WL + S = 0 \tag{10}$$

The trade-off between wages and employment is embodied in (10). Employment as a function of wages can be found from (10):

$$L = \frac{2 + \epsilon - W + \sqrt{(2 + \epsilon - W)^2 + 4S}}{2} \tag{11}$$

To ease the calculations the expression for employment is linearized around the natural employment. A first order Taylor expansion yields:

$$L = 2 - W + \epsilon + S \tag{12}$$

(12) has the same qualitative properties as (11). Employment decreases beside wages, increases beside subsidies and fluctuates with ϵ. We refer to (12) as the firm's zero-profit constraint. Naturally, if the union's maximization problem in (7) is carried out using (12) as a constraint (with $S = 0$), the result is the one given by (8) and (9).

The problem of the union is to pick the wage W which maximizes the expected utility, subject to the constraint (12). If the *expected* subsidy $E[S]$ is taken as given, we have:

$$W = 1 + \frac{1}{2}E[S] \tag{13}$$

(13) denotes the optimal wage setting, given that the expectation to the subsidy is $E[S]$, i.e. (13) is the union's reaction function. Wages show a linear increase beside the expected subsidy $E[S]$. If $E[S] = 0$, the wage is $W = 1$, as found in (8).

The government

The government has an employment target for the firm and a target for the subsidy. This can be expressed by the following utility function V for the government:

$$V = -\alpha(L-2)^2 - S^2 \tag{14}$$

If $L < 2$ the government obtains higher utility because employment increases; $L = 2$ is the government's employment target. Thus, the government's employment target is higher than the "natural employment" $E[L] = 1$, as shown in (9).[5] The utility decreases when the subsidy differs from 0 because the government is concerned about the balance of the budget.[6] $\alpha \geq 0$ denotes the government's relative stress on the employment target; the higher α is, the more the government emphasizes the employment target.

[5] The government's employment target is chosen such that it yields as simple solutions to the game as possible. In the absence of shocks, if $L = 2$ the output price is $P = 0$, which is unrealistic. On the other hand, the expected output never reaches this level.

[6] The model could be extended to include the possibility of the subsidy being negative, in which case the subsidy would amount to a tax. The utility function of the government would then have to be changed so that it included a tax target. If the tax target is labelled $\Gamma \leq 0$, the government's utility function takes the form:

$$V = -\alpha(L-2)^2 - (S-\Gamma)^2$$

See also footnote 7.

Let us consider the problem that the government faces. The government observes the shock prior to its setting of the subsidy. If the government takes the union's wage setting, W, as given, the problem is to choose the subsidy, S, so that the utility is maximized given the ZP-constraint (12):

$$\begin{aligned} &\text{Max} \quad -\alpha(L-2)^2 - S^2 \\ &\text{s.t.} \;\; L = 2 - W + \epsilon + S \end{aligned} \tag{15}$$

The first order condition implies that the government's best response to the union's wage setting W is:

$$S = \frac{\alpha}{1+\alpha}W - \frac{\alpha}{1+\alpha}\epsilon \tag{16}$$

(16) is the equation for the government's reaction curve. If $\alpha > 0$, the subsidy increases when the wage increases (to limit the employment consequences of the wage increase). The subsidy moves counter-cyclically; a (numerically) large negative shock is accompanied by large subsidies.

5. The discretionary equilibrium in the one-period game

In this section we consider a one-period non-cooperative game in which the union moves before the government; the solution to this game is labelled the discretionary equilibrium. In section 6 the sequencing of the players' moves are altered as the government implements its subsidy policy before the union moves.

For the discretionary equilibrium the following sequencing of the game is assumed:

— *The union sets wages, W.*
— Nature selects the shock, ϵ.
— *The government sets the subsidy.*
— The managers set employment, L.

The union sets wages prior to the government's setting of the subsidy. Thus the union takes into account the government's likely subsidy when it sets wages. This resembles the case in which the government is "captured" by the union, as seems a quite likely event in the transition economy (cf. section 2). The union sets wages initially; afterwards the government must bail out the firm in order to maintain the employment.

The discretionary equilibrium is found when the union maximizes its expected utility with respect to the wage, subject to the ZP-constraint (12) and the government's reaction curve (16):

$$\text{Max } E[WL]$$

$$\text{s.t. } L = 2 - W + \epsilon + S \tag{17}$$

$$S = \frac{\alpha}{1+\alpha}W - \frac{\alpha}{1+\alpha}\epsilon$$

The solution to this problem is:

$$W = 1 + \alpha \tag{18}$$

$$L = 1 + \frac{1}{1+\alpha}\epsilon \tag{19}$$

$$S = \alpha - \frac{\alpha}{1+\alpha}\epsilon \tag{20}$$

If $\alpha = 0$ the subsidy is $S = 0$. The wage is $W = 1$ and, likewise, the employment equals natural employment. $\alpha = 0$ resembles a situation in which there is no government (cf. section 3).

Now, assume that $\alpha > 0$ and consider the deterministic version of the model, i.e. $\epsilon = 0$. It this case $W = 1 + \alpha$, the employment equals the natural employment $L = 1$, and $S = \alpha$. The wage is above the wage found in (8). The more the government stresses the employment target, the higher the equilibrium wage is. The firm knows that it will be bailed out by the government and therefore sets wages above the "natural rate". The subsidy $S = \alpha$ is exclusively carried into higher wages and has no effect on employment. The union has "captured the government" and "wages are way above market wages".

Finally, consider the results for the model with stochastic shocks. When $\alpha > 0$ employment varies less than in the case in which there is no government, i.e. the government's counter-cyclical subsidies reduce the employment variation. The higher α is, the more the government stabilizes. Average employment, however, equals natural employment.

We conclude that when the government pursues a stabilization policy through discretion, employment is stabilized. However, there is a cost as the subsidy is partially carried into higher wages without there being any effect on employment.[7]

[7] If we had included a target for the subsidies different from 0, as suggested in footnote 6, the subsidy in the discretionary equilibrium would have been:

$$S = \alpha - \frac{\alpha}{1+\alpha}\epsilon + \frac{1}{2}\frac{2+\alpha}{1+\alpha}\Gamma$$

The expected subsidy is negative (a "tax") if Γ is a sufficiently large negative number.

For later use we calculate the government's expected utility when it plays according to a state-contingent discretionary rule, $E[V^D]$:

$$E[V^D] = -\alpha(1+\alpha) - \frac{\alpha}{1+\alpha}\sigma^2 \tag{21}$$

The discretionary equilibrium illustrates the emergence of a soft budget constraint in the transition economy. The government likes employment and pays subsidies to increase employment levels. This is anticipated by the union which sets high wages without taking into account the profitability of the firm; the union knows that the government will bail out the firm. Average employment is not influenced by the payment of subsidies.

It must be emphasized, however, that the non-cooperative equilibrium arrived at in this section is not the only possible outcome of the game. The discretionary equilibrium—a Nash equilibrium—only ensures that each player's move is optimal, given the other player's move and the sequencing of the game. Other solutions to the model in *Section 5* are possible if the players can communicate during the game. In this case the union and the government could bargain and might reach a cooperative agreement which would benefit the union as well as the government.[8]

We will now proceed by discussing the government's possibilities for restraining the payment of subsidies. *Section 6* considers the outcome of one-period games in which the government can commit itself. In *Section 7* the consequences of privatization are discussed.

6. The commitment equilibria in the one-period game

We shall consider the situation in which the government can commit itself to a pre-announced subsidization policy. This implies that, prior to the move of the union, the government fixes its policy rule, i.e. the following sequencing of the game occurs:

— *The government sets the policy rule* for subsidization.
— Nature selects the shock, ϵ.
— *The union sets wages*, W.
— The managers set employment, L.

The government's policy rule can be state-contingent or independent of the shock. Both cases are analyzed below.

[8]For example, see Driffill (1985). Alternatively, we could have considered a repeated version of the game in which the union and the government move simultaneously. A wide range of equilibria can be supported in the infinitely repeated version, including some which make the government better off; e.g. see *Persson and Tabellini* (1990). As argued earlier, however, it is most likely that the agents in the transition economy have a short time horizon. This makes it reasonable to concentrate on the one-shot Nash equilibrium.

Commitment to a state-contingent rule

The government commits itself to a state-contingent policy rule, i.e. the government announces a credible rule for subsidization contingent upon the shock. As the government has a quadratic utility function only linear state-contingent policy rules are considered:

$$S = \gamma + \overline{\gamma}\epsilon \tag{22}$$

The government's problem is to choose the optimal parameters of the policy rule (22), knowing that the union will react optimally to the government's subsidies. Hence, the problem is to pick the γ and $\overline{\gamma}$ which maximize the government's expected utility, subject to the rule (22), the ZP-constraint (12), and the union's reaction curve (13):

$$\begin{aligned} &\text{Max } -\alpha(L-2)^2 - S^2 \\ &\text{s.t. } S = \gamma + \overline{\gamma}\epsilon \\ &L = 2 - W + \epsilon + S \\ &W = 1 + \tfrac{1}{2}E[S] \end{aligned} \tag{23}$$

The solution to the problem in (23) is:

$$W = 1 + \frac{\alpha}{4+\alpha} \tag{24}$$

$$L = 1 + \frac{\alpha}{4+\alpha} + \frac{1}{1+\alpha}\epsilon \tag{25}$$

$$S = \frac{2\alpha}{4+\alpha} - \frac{\alpha}{1+\alpha}\epsilon \tag{26}$$

If $\alpha > 0$, the expected subsidy is $S = 2\alpha/(4+\alpha)$, the wages are $W = 1+\alpha/(4+\alpha)$, and the expected employment is $E[L] = 1 + \alpha/(4+\alpha)$. It can be seen that—for the same α—the expected subsidy is lower in the state-contingent commitment equilibrium than in the discretionary equilibrium. The wages are lower and the average employment is higher. The degree of employment stabilization is the same in the two equilibria (cf. the coefficient to ϵ). Also, the soft budget constraint emerges in the commitment equilibrium; the government pays subsidies in order to increase employment. Notice, however, that in the commitment equilibrium the government actually obtains higher expected employment in "exchange" for the subsidy. This was not the case with the discretionary equilibrium.

Now, let us compare the outcome of the games when the government cannot commit itself and when it has the ability to commit itself to a state-contingent rule. The reaction to the shock is the same in both cases, but in the discretionary equilibrium the employment is lower and the subsidy higher than in the commitment equilibrium. Thus, it follows that—if $\alpha > 0$—the government is better off in the commitment equilibrium than in the discretionary equilibrium.

Commitment to a simple rule

A more realistic case might be the situation in which the government commits itself to a policy rule independent of the exogenous shock, i.e. a simple rule. In this equilibrium the government does not require any informational advantage—but the government has to set its subsidies before the wages are set.

The government's policy rule is the same as the one in (22), but $\overline{\gamma} = 0$. The government's maximization problem yields the following results:

$$W = 1 + \frac{\alpha}{4+\alpha} \tag{27}$$

$$L = 1 + \frac{\alpha}{4+\alpha} + \epsilon \tag{28}$$

$$S = \frac{2\alpha}{4+\alpha} \tag{29}$$

The wage is the same as in the case in which there is a state-contingent commitment rule. The exogenous shocks are carried fully into employment fluctuations because the subsidy does not depend on the shocks. The expected employment is the same as for the state-contingent rule and higher than in the discretionary equilibrium.

The state-contingent commitment rule is clearly better for the government than the simple rule. (This follows from the fact that $\overline{\gamma} \neq 0$ in the state-contingent commitment equilibrium). When is the simple rule better than discretionary policies for the government? For that purpose we have to calculate the government's expected utility when it commits itself to a simple rule:

$$E[V^S] = -\frac{4\alpha}{4+\alpha} - \alpha\sigma^2 \tag{30}$$

Now, the government is better off committing itself to a simple rule than by playing discretionary policies if $E[V^S] \geq E[V^D]$, i.e.:

$$\sigma^2 \leq \frac{(1+\alpha)(5+\alpha)}{4+\alpha} \tag{31}$$

If the variance is sufficiently small, the simple commitment policy is better than discretion. The intuition behind this result is the following: if the government commits itself to a simple rule it does not suffer a loss by paying subsidies that have no employment effect; on the other hand, it loses its ability to stabilize employment. If the shocks are sufficiently small, the expected utility gain from the reduced subsidy payments will dominate the expected utility loss from the increased employment fluctuations.

This section has shown that the government is always better off if it can commit itself to a state-contingent subsidy policy; also, a simple rule is beneficial if the shocks are expected to be small. Both commitment rules require that the government announces a credible rule for subsidization before the union moves. Whether this is possible for the government is uncertain. Tirole (1991) points out that pressure from abroad might be one way to harden the soft budget constraint and thus lend credibility to the government's announcement. For example, the pressure could stem from international lenders and financial institutions that make their lending contingent on the government's ability to restrain the payment of subsidies. This would make it costly for the government to renege on its announcement.

7. The prospect of privatization

In most of the transition economies the final goal is to create market economies with private ownership. The process of privatization has, however, been complicated by the large number of state-owned firms and undeveloped capital markets.

Various privatization schemes for the East European economies have been suggested—for example, *Borensztein and Kumar* (1991).[9] The proposals can broadly be divided into two categories:

— Proposals in which ownership is transferred to a limited number of privatization companies or financial intermediaries. These holding companies are then owned either by the state, by the citizen, or some combination of these. The holding companies supervise the management of the firms, and they might be assisted by banks and foreign consultants.

— Proposals in which the firms are sold to private domestic or foreign owners. The owners can either be shareholders who hire the managers, or owners who implement direct hands-on management.

The approaches of the two categories are not mutually exclusive. First, as argued in the introduction, it has become evident that the individual sale of firms to private owners is a slow way of privatization and might have adverse distributional consequences. Second, the ownership structures can coexist. Third, it is likely that

[9] The standard reference concerning privatization is *Vickers and Yarrow* (1988).

in the long run the holding companies will be dissolved when they sell their firms to private owners.

The model in this paper is too simple to illustrate the host of issues concerning the privatization of the state-owned firms. The most important point is that the model does not concern itself with the productive efficiency associated with various ownership structures. The model, however, illustrates the occurrence of a soft budget constraint, and from this viewpoint the model is used to discuss whether privatization of state-owned firms can benefit the government.

A holding company which does not care about employment

Let us initially consider an extreme case of "privatization in holding companies"—namely the case in which the government transfers the ownership of the firm to a holding company which does not care about employment. In the short run the microfoundation of the firm does not change, i.e. the firm is still labour managed and faces a ZP-constraint.[10] Furthermore, it is assumed that the firm has no economic relationship with the government any more and consequently the firm considers the holding company to be its only source of subsidies.[11]

Here we will consider a holding company that has the same utility function as the government, i.e. (14), but the holding company's stress on the employment is labelled β (instead of α). The holding company does not care about employment at all—i.e. $\beta = 0$—so the holding company has a dominant strategy in this case, namely $S = 0$; the holding company refuses to pay subsidies to the firm irrespective of the union's wage setting or the realization of the demand shock. The employment becomes $L = 1 + \epsilon$ (cf. *Section 5*).

Also, the government pays no subsidies when the firm is privatized. Thus, the government's expected utility when the firm is transferred to a holding company is:

$$E[V^0] = -\alpha(1 + \sigma^2) \tag{32}$$

The government's expected utility if it does not privatize depends on the government's ability to commit itself. Therefore, the desirability of privatization depends on the equilibrium if the government does not privatize.[12]

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[10] In the long run the microfoundation will change because the holding companies will seek to maximize the profits from its firms. However, the restructuring will take time. Thus in the short run it is unlikely that the objectives of the firms owned by the holding company will change much.

[11] This is, of course, a simplification. The firm must still pay taxes and it is influenced by the government's overall credit policy.

[12] The same conclusion is reached by *Schmidt* (1991) using a somewhat different approach: the budget constraint is harder if a firm is privatized, rather than being state-owned because of

If the government plays a discretionary policy its expected utility is given by (21) in *Section 5*. $E[V^0] \geq E[V^D]$ if:

$$\sigma^2 \leq 1 + \alpha \tag{33}$$

If (33) is satisfied, the government can be expected to be better off by transferring the firm to a holding company with $\beta = 0$, than by playing discretionary policies. Hence, if the shocks are not too large the government's expected utility increases if the firm is privatized. The intuition behind this result is the same as for the equilibrium with a simple commitment rule. When the government transfers the firm it avoids paying subsidies but it also loses ability to stabilize employment. If the variance of the shocks is sufficiently small, the expected utility gain from the reduced subsidy payments dominates the expected utility loss from the increased employment fluctuations.[13]

If the government can commit itself, it is better off if it keeps the firm as a state-owned firm, rather than transferring it to a holding company with $\beta = 0$. This follows from the fact that the government could choose to play an expected $S = 0$ in the commitment equilibrium with a state-contingent or a simple rule, but chooses to play $E[S] > 0$. The reason for this result is that the government in the commitment equilibrium is able to raise employment above the natural level by paying subsidies. Hence, if the government can commit itself it never pays to privatize a firm by handing it over to a holding company which does not care about employment.

A "conservative" holding company

The assumption in the last subsection—i.e. that the firm cannot attract any subsidies from the holding company—might be unrealistic. The holding company might be interested in production and, hence, in the employment of the firm. Furthermore, it might be able to subsidize the firm for limited periods of time or—more realistically—the holding company might eventually be bailed out by the government if it has to support its firms.

We consider again a situation in which the ownership of the previously state-owned firm is transferred to a holding company and the firm is still labour managed. The holding company is partly dependent on the government in the sense that the

informational asymmetry. Hence, the government's threat to stop paying subsidies is more credible when the firm is privatized, because in this case the government has no reliable information about the costs and profits of the firm.

[13] In this case the threshold value of σ^2 is lower than the one found for the simple commitment rule (31), i.e. the simple commitment rule is favourable for an interval of shocks rather than for the transfer of a firm to a holding company with $\beta = 0$.

government pays if the holding company bails out firms by subsidizing them.[14] (In practice it is probably more conceivable that the government will have to bail out the holding company if too many of its firms are in the red).

Given that the relationship between the holding company and the firm is the same as in the discretionary equilibrium, what are the optimal preferences of the holding company from the viewpoint of the government?[15] The holding company has the same utility function as the government, i.e. (14), where β denotes the holding company's stress on the employment target. The outcome of the discretionary equilibrium would be the same as in (18) through to (20) with β inserted instead of α. Now, the government's problem is to pick the β that will solve the following programme:

$$\text{Max} \quad -\alpha(L-2)^2 - S^2$$

$$\text{s.t. } S = \beta + \frac{\beta}{1+\beta}\epsilon \tag{34}$$

$$L = 1 + \frac{1}{1+\beta}\epsilon$$

The first order condition to this problem is:

$$\frac{\alpha-\beta}{(1+\beta)^3}\sigma^2 - \beta = 0 \tag{35}$$

It follows from (35) that $0 < \beta < \alpha$, i.e. the holding company must stress the employment target less than the government. The firm takes into account the holding company's lower emphasis on employment and reduces its wage demands accordingly. The government prefers a holding company which places only a light emphasis on the employment target, for it is the latter that is carried into the expectations of the union. On the other hand it does not want a holding company which does not stress the employment target at all ($\beta > 0$), for this would create employment fluctuations that would be too high. The holding company has to be "conservative" but not too "conservative".

This might provide a good argument for the immediate transfer of state-owned firms to holding companies, even if the government has to subsidize the holding companies. If the firms perceive that they are playing against a tougher player, the budget constraint is hardened and the government is better off.

[14] The German "Treuhandanstalt" is an example of such a construction.

[15] The idea behind this modelling of privatization in holding companies is derived from the literature on monetary policy games. *Rogoff* (1985) suggests that monetary policy be delegated to a "conservative central banker" who stresses an employment target lower than that of the government. This makes the government better off.

Sale to private owners

Finally, let us consider the sale of the firm to private owners. This is modelled by the assumption that the microfoundation changes so that the (new) private owner maximizes profits. Besides this it is assumed that the firm receives no subsidies from the government.

Assume that the owner maximizes the expected profit in (5) taking the wages as a given parametric. In this case the expected employment equals:

$$E[L] = 1 - \frac{1}{2}W \tag{36}$$

The expected employment is below "natural employment" that is equal to 1, as can be found in *Section 3*.

The union knows the private owner's (expected) labour demand but does not observe the exogenous shock. Assume that the union still sets wages in order to maximize the expectation with utility (6), subject to the labour demand schedule. This yields the following wages and employment:

$$W = 1 \tag{37}$$

$$L = \frac{1}{2} + \epsilon \tag{38}$$

The wages are seen to be the same as when the firm was state-owned but labour managed. The employment level, however, is lower in the privately owned firm (compare with (8) and (9)). The private owner exploits the monopoly by reducing production and hence employment. This might be an unwanted side effect of selling to private owners; it is a side effect which can be avoided most effectively by reducing the monopoly power of the firms prior to privatization.[16] This concern

[16] The conclusion above does not hold, however, if the private owner does not consider the wage as a given parametric. If the union maximizes its utility function (6) its first order condition is:

$$L + W\frac{\partial L}{\partial W} = 0$$

where, for simplicity, the exogenous shock is ignored. The private owner's problem is to maximize profits so as to yield this first order condition:

$$2 - 2L - \left(\frac{\partial W}{\partial L}L + W\right) = 0$$

If the private owner takes into account the union's wage setting change in relation to the employment, the owner will employ $L = 1$ (in the absence of exogenous shocks). This is a case in which the monopoly union model implies higher employment than market-determined wages. The reason is that the union is willing to accept lower wages in order to get higher employment, and this leads the private monopolist to increase production.

for employment consequences in connection with privatization is briefly pointed out in Pinto et al. (1992).

To summarize, privatization in holding companies is a way to harden the firm's (and the government's) budget constraint. The government will prefer a "conservative" holding company but that company must not be too conservative. However, even a holding company which does not care about employment might be favourable to the government. Otherwise, if the government has to rely on discretionary policies, such a privatization seems favourable in economies in which the shocks are not too large. Finally, the sale of the firm to a private owner might be another way of hardening the budget constraint; the risk is reduced employment if the owner is able to exercise monopoly power on the goods market.[17]

8. Final comments

This paper has emphasized that it is possible for the soft budget constraint of the socialist economy to be carried into the transition economy. One of the reasons for the emergence of a soft budget constraint in the transition economy is the government's concern for employment; the government is willing to subsidize the firms in order to increase employment. When this is understood by the unions in the state-owned firms, there is an incentive to press for excessively high wages; the unions know that the government will bail out the firms.

Two ways to remedy the problems of the soft budget constraint have been proposed. The government might be able to commit its subsidy policy to a rule. In this case the government will still pay subsidies, but it will also manage to increase average employment. This kind of commitment might require some kind of external pressure for it to be credible.

Another option was to proceed with the privatization of the firms. Two categories of privatization scheme were identified. One approach was to transfer the ownership of the state-owned firms to some kind of holding company; in this case the incentive structure of the firm might be unchanged in the short run, but the government might still be able to limit its payment of subsidies. The other approach was to sell the firms to capitalists, thus introducing a completely new economic framework for the functioning of the firm. The latter approach might have the short run consequence of reduced employment within the firm.

Naturally, the analysis in this paper of the problems related to the soft budget constraint does not encompass the wide range of problems concerning privatization of state-owned enterprises in the transition economy. There are many forms of

[17] It might still be possible for the government to subsidize the firm even if it is transferred to a holding company or sold to a private owner. A breakup of the formal link between the government and the firm might, however, be a step towards limiting the temptation to subsidize the firm.

ownership, each of these implying a specific underlying incentive structure. This paper, however, isolates one of the obstacles to (and necessities for) reform in the former socialist economies arising from the ownership structure, as well as the interaction between enterprises and the government in the transition economy.

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List of symbols

$E[V^S]$ = the government's expected utility when it commits itself to a simple rule
$E[V^D]$ = the government's expected utility when it plays discretionary
$E[V^0]$ = the government's expected utility when a firm is owned by a holding company which does not care about employment
L = employment
P = price
U = the union's utility
V = the government's utility
W = nominal wage
S = subsidy
Y = (real) production
α = the government's stress on the employment target
β = the holding company's stress on the employment target
γ = constant in the government's commitment rule
$\overline{\gamma}$ = state-contingent term in the government's commitment rule
Γ = the government's tax target
ϵ = exogenous demand shock
Π = profit
σ^2 = variance of the exogenous demand shock

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LEGAL REFORM FOR HUNGARY'S PRIVATE SECTOR

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Hungary has been on the forefront of CEE countries in reforming its legal framework to promote private sector development. Despite its achievements, however, numerous legal and institutional challenges remain in such areas as real property, bankruptcy, and competition law. Furthermore, the challenge of implementing new legislation is daunting, particularly given the country's limited experience with market principles and institutions. Both specialized institutions and regular courts are overwhelmed with the burgeoning caseload. In addition to substantive review, training, and technical assistance, Hungary should work to provide widespread dissemination of both court and regulatory rulings, both to educate the public and to promote public accountability and oversight.[1]

Hungarian legal reform for the private sector

Hungary is in the midst of a fundamental transformation towards a market economy. Although it has long been in the forefront of efforts to reform socialism itself, after 1989 the goals of reform changed from market socialism, and the idea of widespread private ownership gained acceptance. The legal framework—the "rules of the game" is now being geared towards encouraging, protecting, and rewarding entrepreneurs in the private sector.

This paper describes the evolving legal framework in Hungary in several areas—including constitutional, real property, intellectual property, company, foreign investment, bankruptcy, contract, and antimonopoly law.[2] These areas of law serve to define (i) property rights, (ii) the means to exchange them, and (iii) the rules for competitive market behaviour.[3] The paper also addresses the capacity of Hungary's legal institutions to implement the new legal reforms. As in the other

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[1]The authors would like to thank Izak *Atiyas* (IENIN) for extensive contributions in the area of bankruptcy law; Richard *Hirschler* (CECSE) for updates of the material; and the US Agency for International Development for supporting the work of Michael Heller through the Joint Bank/A.I.D. Urban Action Plan for Hungary.

[2]This paper is part of a larger research project sponsored by CECSE and LEGEC to study evolving legal frameworks in Eastern Europe. Other studies include Gray et.al., *The legal framework for private sector development in a transitional economy: the case of Poland* ("*Poland*"), Gray et.al., *Romania's evolving legal framework for private sector development* ("*Romania*"), Gray and Stiblar, *The evolving legal framework for private sector development in Slovenia*, and Gray and Ianachkov, *Bulgaria's evolving legal framework for private sector development.*

[3]This paper does not discuss certain other areas of law that are also important to the private sector, including privatization, banking, taxation, and labor law. Although a critical area of reform, privatization is a transitional issue, whereas the paper seeks to address the longer-term legal structure.

countries of Central and Eastern Europe (CEE), defining real property rights and creating the conditions for free and fair competition are perhaps the most contentious and confused areas in the current legal landscape.

Constitutional law

No written constitution existed in Hungary before 1949. Rather, constitutional principles were derived from various pieces of legislation, similar to the tradition of England. In Act XX of 1949, the People's Republic of Hungary adopted a Constitution based on the Soviet model. Under this Constitution the economy was based on the concept of "social ownership of the means of production" (Section 6(1)), a vague notion akin but not identical to state ownership. This Constitution also established the primacy of the national economic plan in guiding the economy (Section 7).

In 1972, this Constitution underwent extensive amendment in order to accommodate the New Economic Mechanism of 1968.[4] For example, for the first time it recognized and protected personal property and the economic activities of small-scale private producers of commodities (Sections 11 and 12).

On October 18, 1989, Parliament passed the most significant constitutional revisions to date. This amendment is often referred to as the "new" Hungarian Constitution, as approximately 80 percent of the 1949 version was abrogated. Drafted on the threshold of Hungary's democratic and economic reforms, the amendment was a political compromise between the old school communists and the new generation of politicians gradually replacing them. The new version was subsequently amended several more times in 1990. It is unclear how long this version of the Constitution will remain in force. Its preamble envisions it as a transition document, but no further fundamental revision is expected in the near future.

Rights and duties of citizens

Much of the amended Constitution deals with rights and duties of citizens. Chapter I deems Hungary a democratic constitutional state and asserts its com-

[4] The New Economic Mechanism was Hungary's first major attempt at economic reform. It maintained national planning but ended the practice of imposing production targets on state-owned enterprises. Rather, a system of economic regulations and incentives (e.g. taxes, prices, and credit policy) was designed to induce firms to meet national planning targets. Most of the lessons of that period were, however, negative, as decentralization led to overinvestment and lack of fiscal discipline exacerbated macroeconomic imbalances without significantly increasing efficiency. See *Kornai* 1986; *Gelb and Gray* 1991; *Sajó* 1990.

mitment to a market economy and its encouragement of entrepreneurship and competition. It establishes protection of private property, including compensation in the event of expropriation, and general rights to freedom of association. Most of the fundamental rights and duties of citizens are contained in Chapter XII. These include rights to liberty, personal safety, and freedom from torture. Democratic rights, such as freedom of thought, speech, the press, and religion, are also guaranteed. These latter rights, as well as the right to compensation in the event of expropriation, were also guaranteed by Hungary's socialist constitution, but were always subject to the higher "interests of socialism".

Other sections of the Constitution promise certain economic rights. Labor is guaranteed "the right to work, to freely choose [a] job and occupation" and "to have an income [commensurate] with the quantity and quality of the work performed by him/her" (Section 70/B). Every woman is guaranteed pre- and post-natal care (Section 66), and children are guaranteed "all the protection and care required for proper physical, mental and moral development" (Section 67).

Structure of government

Section 2 declares Hungary a democratic constitutional state based on the separation of powers among Parliament, the Council of Ministers, and the Judiciary. The unicameral Parliament has 386 members[5] elected for four year terms. Its primary legislative duty is to pass laws and constitutional amendments. Any legislation affecting the fundamental rights of citizens must take the form of a Parliamentary Act.

Parliament elects Hungary's highest ranking officials, including the President, the Council of Ministers, the Parliamentary Commissioners of Citizens' Rights, the President and Vice-Presidents of the State Audit Office, the President of the Supreme Court, and the Chief Public Prosecutor (Section 19). A member of Parliament, the President, or the Council of Ministers may introduce legislation. After proposals are passed by Parliament, they must be signed by the President to become law. The President may refuse to sign an Act of Parliament by passing questions about the Act to the Constitutional Court. The precise boundaries of presidential power to veto executive decisions of the government remain unclear,[6] but in

[5] The current Parliament was elected in 1990 based on the negotiations embodied in Act XXXIV of 1989 on the Election of MPs. Rules governing MP status, including immunities, are governed by Act IV of 1990 on the Legal Status of MPs.

[6] See, e.g., "Court vague on Göncz–Antall media debate", *Budapest Week*, June 11–17, 1992, at 3 (Constitutional Court decision on "the country's hottest political debate since the elections, pitting the [President and Prime Minister] against each other, [concerning] their respective rights to hire and fire people in key positions".).

general the President has much less power than the President of either Poland or Czechoslovakia.

The Constitutional Court

The Constitution also introduces Hungary's first Constitutional Court.[7] This court is composed of 15 judges elected by Parliament. Each sits for a nine year term, which may be renewed once. These judges are prohibited from political activity and party membership, a restriction that applies to local and county judges as well. The Court's purpose is to interpret the constitutionality of legal rules, including international agreements, and to annul parliamentary acts and other regulations it finds unconstitutional.[8] It may also review draft laws before they are voted upon in Parliament, although in reviewing draft laws, the court has sometimes been accused by members of Parliament of impinging on legislative authority.

The Hungarian Constitutional Court has extremely broad jurisdiction, perhaps the broadest of any constitutional court in the world. Valid complaints are not limited to contesting the constitutionality of existing laws and administrative regulations, but they extend even to allegations of "negligence" against the legislature for not having passed a law, if such law's absence creates an unconstitutional situation.[9] If the court agrees that lawmakers should have passed such a law, Parliament is given a limited period of time in which to pass the missing legislation, although the procedure for enforcing this time limit is unclear. (Pataki 1991, p. 7)

Not only does the Court have broad jurisdiction, but it also allows extremely broad access. Under the court's rules any citizen is entitled to present a complaint to the court. The rules of open access and permissible claims have led to a virtual

[7] Act I of 1989 establishes the Court. Its purposes are detailed in Act XXXI of 1989, and detailed regulations on structures and procedures are set out in Act XXXII of 1989.

[8] The power automatically to annul laws and regulations is strong relative to the powers of other constitutional courts in the region. For example, the decisions of Romania's and Poland's Constitutional Courts can be overturned by a two-thirds' vote of their respective Parliaments. See Gray, et al, *Poland* and *Romania*, supra note 2. In Hungary, the Parliament may not overrule a Constitutional Court decision except by changing the Constitution. For example, in a case concerning the voting rights of expatriate Hungarians, the Parliament passed an Act, the Court struck it down, and the Parliament then implemented the Act by amending the Constitution.

At present, regular courts, including the Supreme Court, are not allowed to declare an Act or regulation unconstitutional, although they may stay a case and refer the matter to the Constitutional Court. There are discussions to amend this procedure so that regular courts can also rule on the constitutionality of laws and regulations, with appeal to the Constitutional Court.

[9] See *Pataki* 1991. The Court has interpreted its jurisdiction to hear such omission cases to be limited to those situations where the missing regulation is affirmatively required by a higher Act or Decree, or where the omission violates basic rights.

flood of cases.[10] About 1500 cases were filed and 235 cases decided in 1990. In 1991, 2200 cases were filed, of which about 400 were accepted for review (the balance being dismissed as moot, repetitive, or otherwise technically flawed) and about 250 were decided. Of these decisions, about 50 resulted in annulment of laws or regulations.

Rights to real property

Defining basic ownership rights

Redefining ownership rights.[11] Hungary has gone far over the past years in redefining property rights and removing the stigma and legal impediments attached to private[12] ownership. The Constitution and Civil Code have been amended, and many other laws affecting rights in real property have been adopted (as discussed below). Section 9(1) of the newly amended Constitution abolishes the preferential treatment of socialist property by granting private property equal rights and protection. In support of this right, Sections 13 and 14 of the Constitution guarantee compensation in the event of expropriation of property. The Civil Code (Para. 177) also guarantees "adequate compensation" for property expropriated for the public interest.

As with the Constitution, the most important provisions on property in the Civil Code have been amended. Private ownership is now fully accepted in Hungary, and the privatization program is attempting to transfer the bulk of state assets into private hands. (Hanson 1992) Law XIV of 1991 abolished all forms of socialist ownership, abrogated privileges of state and cooperative ownership as related to private ownership, reviewed the range of exclusive state property and inalienable assets, and empowered the state to cede certain property, such as forests and land, to private owners. Remnants of the prior system in related Code sections are no longer enforced and should be interpreted in the spirit of the recent amendments, a necessary process pending a thorough overhaul of the Civil Code. Although these prejudicial provisions of the Civil Code could perhaps be eliminated with a quick amendment as was done in Poland,[13] the Hungarians have opted to undertake a

[10] Plans to limit this access by requiring the litigant to have a direct interest are under active consideration. Other countries often restrict access to constitutional courts. For example, in the United States one can present a constitutional issue to the Supreme Court only if one has been directly affected by the issue, and the Supreme Court has discretion whether to consider the case.

[11] A. Nemeth, personal interview, June 5, 1992; see also *Oltay* 1991.

[12] Hereinafter "private" property refers to any individually-owned property, rather than the narrower socialist usage of the term.

[13] See Gray et al, *Poland*, supra note 2.

more systematic revision to the Code over the next several years under the auspices of a special codification committee appointed by the Ministry of Justice. (*Sárközy* 1990)

In the area of real estate, Act I of 1987 on Land[14] (as amended through 1991) has been instrumental in freeing up the private market for real estate. This Act, which covers not only land but also buildings and other constructions, defines the rights of owners and users and clarifies conditions for the purchase and sale of real estate. Although somewhat unstable in its specifics due to continual amendment, (Sárközy 1990, ch. III, p. 3.) this Act has served the important function of removing the administrative barriers to private acquisition of real estate. For example, it eliminated the "trustee-management" form of land-holding common during socialist times, and it lifted the former 50 hectare maximum on private land ownership. Now a private Hungarian person (either natural or legal) may acquire real estate without any legal limitation. However, other practical impediments discussed below, such as ambiguity to title and access to credit, continue to retard the development of a real estate market.

Foreign ownership. Under Act I of 1987 on Land, foreigners are prohibited from owning agricultural land (unless allowed by another law). Foreigners may, however, own non-agricultural land and immovable real property after receiving permission from the Ministry of Finance.[15] This permission is guided by the discretionary standard that the purchase may not "harm the Hungarian State or its autonomy, does not harm local governments,[16] nor cultural and touristic interests". Apparently, Hungarian expatriates whose property was expropriated can secure this permission easily; similarly, foreigners who buy out their partners in a joint venture also tend to obtain permission.

In contrast, Hungarian corporate entities that are either partly or even wholly foreign owned are entitled to own real property under the Foreign Investment Act of 1988, discussed below. The only limitation on this ownership is that, under Section 19, the property must be related to the company's objectives. The original purpose of this limitation was to prevent proper business purpose.

[14]The Act of Land in uniform pattern with Decree 26/1987 (VII.30) MT by the Council of Ministers and Decree 8/1987 (IX.1.) MEM by the Minister of Agriculture, translated in Hungarian Rules of Law in Force I./Nr. 10, Budapest, 1990, June 1.

[15]Section 38(1). Foreigners are defined as natural persons who are not Hungarian citizens, Hungarian citizens domiciled abroad, and business organizations not created under Hungarian law. An exception for Hungarians domiciled abroad allows them to own property through inheritance.

[16]Local governments have the power to veto a sale. See Invest in Hungary, 1991/6 at 29.

Assigning and securing title

Once basic rights to private property have been defined, the next step is linking those rights with specific owners. This is the most controversial aspect of reform, as it raises the possibility of a redistribution of assets that could decidedly influence the pattern of wealth for the foreseeable future.

Clarification of state property ownership. The need to define owners applies to both public and private sectors. On the public side, assigning specific ownership rights to state-owned property (including property of state enterprises, public office buildings, and public housing) to various levels of government is proving problematic in Hungary, as in several other CEE countries.[17]

Two recent laws address this thorny question. First, Act LXV of 1990 on Local Government transferred control over all state enterprise property to the State Property Agency responsible for privatizations. (Sárközy 1990, ch. III, p. 6.) Under this law, disputes still persist among the municipalities, the districts, and the State Property Agency as to ownership of enterprise specific property. Second, Act XXXIII of 1991 on the Transfer of State Property to Local Authorities[18] transferred to local governments ownership rights in most other state-owned real property-including apartments, non-residential units such as small shops, and numerous other state-owned buildings.[19] The Ministry of the Interior is charged with implementing this Act by setting up district and county level committees to review each land parcel transfer.

Claims of former owners. Title to both publicly and privately held real estate is not likely to be complicated by restitution (or "reprivatization") in Hungary as it is in Poland, Romania, East Germany, Czechoslovakia, or Slovenia.[20] Hungary's solution to the perceived injustices caused by socialist expropriations is Law XXC, the Compensation Act of 1991. This law partially compensates both Hungarians and foreigners whose property was expropriated through regulations enacted after 1939. Compensation takes the form of lump sum payments in the form of coupons, the amount of which is determined by the value of the nationalized property. Damages measuring up to HUF 200,000 will be compensated 100%;

[17] The problem is particularly acute in Poland, where the move to decentralize government has been very strong. See Gray et al, *Poland*, supra note 2.

[18] *Magyar Közlöny*, Aug. 2, 1991, 87. szám, Paras 1–2. This act also transfers historical architecture (para. 3), undeveloped land not covered by the Transformation Act XIII of 1989 (para. 9), public utilities exclusively serving that community (para. 11), public transportation (para. 14), and certain parks (para. 25).

[19] Conflicting claims now exist between the two levels of local government, the municipalities and the districts. Buildings on plots of land larger than 1000 square meters are transferred to the State Property Agency, and the lesser are transferred to the Hungarian Treasury Trust under the Ministry of Finance.

[20] See various country studies cited in note 2.

from HUF 200,001–300,000, 50%; from HUF 300,001–500,000, 30%; and over HUF 500,001, 10%. The maximum payment will be HUF 5 million.[21]

The coupons function as transferable bearer securities and pay interest (75% of the basic interest rate of the central bank) until the summer of 1994. Compensation coupons may be used as full or partial payment for property sold by the state, including apartments, shares in privatized state-owned industries, and farmland.[22] A separate law is planned to enable the coupons to be transformed into life annuities to provide social insurance for their holders. It also seems possible to pledge the coupons as collateral for loans.[23]

Only former land owners may use their coupons to purchase farmland. Such land will be auctioned and sold to the highest bidder.[24] In theory, former land owners may repurchase their original land, if they prove to be the highest bidder and if their particular parcel is auctioned off. However, the land that will be auctioned is not likely to be the most fertile; the best land is currently held by cooperatives, which are expected to retain possession of their land under the new law on cooperatives (Law I of 1992 on Cooperatives; see also Law II of 1992 on Rules of Transition). Cooperatives are setting aside 2.4 million hectares and state farms about 4 million hectares for compensation auctions.

During the window for submitting claims (August–October 1991), 805,000 individuals submitted 3.3 million claims worth about HUF 60 billion. About 3 million claims refer to confiscated land. Another HUF 20–30 billion in claims are expected from the extension of the Act to cover claims during the 1939–49 period by Jews and Germans; and a final HUF 20 billion from a proposed extension to cover those politically persecuted. In total, it is estimated that the government will pay out a total of about HUF 100 billion (approximately $1.3 billion). It is expected that about half the vouchers will be used to purchase land and the other half split among apartments, shares in privatized enterprises, rental rights to small shops, and annuities. The distribution of vouchers began March 31, 1992 and is expected to take up to 2 years.

Although Hungary's solution to the restitution problem avoids much of the inequity and inefficiency created by other countries' schemes, some doubt its plan will achieve its restitutionary goals. For example, in light of the shortage of attractive privatized assets, vouchers (and shares bought with them) may in fact be worth only 30% of their face value. Furthermore, alternative investment options (e.g. life annuities) will probably yield insignificant regular payments.

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[21] Compensation Act, Para. 4.

[22] Id., Para. 7–8.

[23] Id., Para. 7.

[24] The original draft Compensation Act of April, 1990, allowed former farmland owners to exchange their compensation coupons for their original land. The Constitutional Court declared this unconstitutional, as it discriminated against former owners of urban and industrial property, who were given coupons but not the possibility of in-kind restitution.

Land registration. Developing an adequate registry to determine legitimate title for privately-owned property is less controversial than allocating property, but it is no less fundamental. As noted earlier, most housing remained in private hands throughout the socialist period. Buyers have always had an incentive to register their purchases in the property registry, because under the Civil Code title passes only when it is recorded in the registry, (Para. 117) and registered owners have priority over other claimants (i.e. unrecorded transaction are not enforceable against third parties). Thus, the existing property registry, which is based on the German model, provides adequate proof of private title in many cases, including private houses and apartments.

This is not to say, however, that the land registry is an accurate portrayal of current ownership in the economy. Some private buyers avoided registration during the socialist period if their individual holdings exceeded permissible levels. Furthermore, nationalizations by the state and transfers among public owners—particularly of trustee rights sold by state enterprises since the late 1970s—were not typically recorded in the land registry; nor were individual flats registered in many large state housing developments. Agricultural land records are in the poorest condition because of extensive nationalizations and regrouping of cooperatives. Finally, missing records, inadequate staff, and lengthy delays in the land registration process—six months being the current norm—add to uncertainty in real estate transactions.

Financing the acquisition of property

Commercial property. On the commercial side, mortgages of real property have long been legally possible. The Civil Code provides for the use of real estate (usually the piece of property being financed) as collateral. (Paras. 265–269) However, such mortgages have been rare, primarily because commercial ventures have been rare. Local financing of commercial property has become more available, at least for property being privatized by the government. The National Bank of Hungary refinances credits extended by commercial banks to private Hungarian citizens for purchasing state assets (including real estate) sold by the State Property Agency ("SPA").[25] Despite this availability of financing, as well as the growing need for commercial mortgages, real estate lenders may be discouraged by the new Bankruptcy Law (discussed below), which grants priority to wages, including severance payments, and tax claims over registered mortgage liens. Direct foreign

[25] This credit may also be used for purchasing shares in companies being privatized at a preferential rate of 75% of the NBH refinancing rate. This scheme is limited to support of the privatization process and is not available to individuals purchasing previously privately-owned or privatized property.

financing of commercial property development is not possible in practice, as foreign banks are prohibited from registering mortgage liens on Hungarian real estate.

Private real estate developers argue that the main constraints are not regulatory—compared with western regulatory hurdles—but are the unrealistically high prices asked by local governments. In addition, local government and SPA requirements for public tenders have tended to stifle deals.

Residential property. As with commercial property, mortgages on residential real estate have long been legally permissable yet little used in practice. Lenders have been discouraged from making substantial mortgages because of the lack of effective legal mechanisms to repossess the collateral in case of default. Tenant protection laws, grounded in the still-applicable 1971 Housing Act, make foreclosure and eviction a cumbersome and futile endeavour. Under this law, those seeking to carry out evictions must provide alternative living quarters—a difficult process giving the shortage of available housing. Because evictions can take up to five years to clear all procedural hurdles, there are few, if any, cases of foreclosure resulting in eviction. Wage garnishment and third party wage guarantees have typically been used as alternatives to secure mortgages, but these alternatives are limited by priorities given to tax, alimony, and other possible claims.

Housing reforms in 1983 allowed captive household deposits to be used as mortgage collateral in lieu of the actual property (*Sagari and Chiquier* 1992) and established a housing finance system of subsidized interest rates. This scheme resulted in a stock of housing loans with market value significantly below its book value—a stock noted as the single most important factor leading to the technical insolvency of Hungary's portfolio-holding institutions. (Sagari and Chiquier 1992) In mid 1991, this old portfolio was cleaned up. The loans were taken away from the banks, borrowers were offered substantial loan forgiveness in exchange for accepting new terms, and the remaining portfolio was returned to the banks as market rate loans with an explicit budget allocation to cover the loan forgiveness.[26]

By 1989 interest rate subsidies were eliminated so that current loans, when they are issued, carry market interest rates—now about 35% for 15 year fixed rate loans.[27] While interest rate subsidies were eliminated, numerous other up-front

[26] After being rejected on procedural grounds in 1990 by the Constitutional Court, the law was correctly passed in mid-1991. The law gave borrowers three options: (1) to have the loan converted to a 15% fixed rate loan with the possibility of having the rate adjusted from year to year; or to have half the loan forgiven—that is, bought out by the government—and the other half (2) repaid in full by the borrower or (3) converted to a market rate loan. To the government's surprise, over 40% paid back the loan, an indication of the monetary overhang in the economy; about 40% converted to market rate loan and the balance took the 15% loan. See *Hegedűs and Tosics* 1991. The Polish Parliament similarly responded to their credit crisis by rewriting existing housing loans to eliminate unsustainable subsidies. Id. p. 2.

[27] See Hungarian-American Enterprise Fund study on the "Creation of a computerized land registry", 21 (1991) quoting rates of 40–50% for terms between 2 and 15 years. The primary mortgage lenders are the National Savings Bank and the Cooperative Savings Bank. Under

subsidies remain, for example, based on the number of children or the purpose of the loan. Because Hungarian banks are inexperienced in underwriting techniques and because fixed rate mortgages are risky in the presence of significant inflation, few mortgages are being written. In practice, banks will make small loans only up to the amount of subsidies covered by the government. Most transactions are conducted in cash.

A final area of concern in financing real property is the legal status of multi-family dwellings, because the availability of clear title to individual units is important if such units are to serve as mortgage collateral. Law Decree 11 of 1977 on Condominiums updates the 1920s condominium law and places Hungary well ahead of many CEE countries. However, inadequacies in the law, particularly in the procedures to secure voting majorities for major decisions, threaten to paralyze the process of renovation and rehabilitation of the Hungarian housing stock.

Regulatory issues

The rental sector. A large and healthy rental sector is one of the best indicators of a well-functioning real estate market, allowing wide household choice and facilitating labor mobility.[28] Hungary's restrictive eviction procedures are the key bottleneck to a fluid rental market. As in the case of mortgage foreclosure, landlords seeking to evict tenants who have defaulted on their rent are obliged first to find an alternative unit for the tenants before evicting them.[29] Unlike the case of mortgage default, renters who default on their rent payments are not subject to garnishment of wages. However, an expedited lease termination procedure is available for certain types of public landlords.[30]

their policy loan maximums are set such that households pay no more than one third of verified household net income.

[28] Labor mobility is particularly critical during this transition period, as many old enterprises are forced into major restructuring or liquidation and newly emerging private firms expand employment opportunities.

[29] The draft Rental Housing Bill currently being discussed would begin the process of removing some of the worst constraints on eviction, particularly by eliminating the requirement that an alternative unit be provided.

[30] The Court Enforcement Office sits at the center of the debt collection and eviction process in Hungary. In 1992, the Budapest Office received about 3,000–4,000 new claims each month for debt collection and had only 16 enforcement officers for the whole city. The Office has not been active in mortgage foreclosures and has rarely pursued evictions in the case of non-payment of rent by renters of privately-owned apartments (of which around 100 private cases were submitted monthly to the Budapest office.) Although courts have rendered thousands of verdicts for eviction, the Office carries out only about 10–30 evictions per year from private rental units, after an average eviction process of 4–5 years.

Rent control for publicly-owned residential property is one of the most politically difficult issues on the current policy agenda. Current rent levels do not allow local governments to recover even operating costs for housing stock, much less capital costs—a condition which has contributed to chronic under-maintenance and the increasingly dilapidated condition of much of the housing stock. According to most observers, central government regulations still determine rent levels for the public housing stock, although some argue that this power has been devolved to local governments. Rents in these units probably will not be raised without clear central government action.

In a second group of quasi-public units, the central government eliminated rent control on "forced tenancies" in January 1992. These 100,000 private units were forcibly created during the period of mass expropriations and allocated according to state rules. Tenants generally now view these units as public housing and have resisted owners' attempts to raise rents since January, usually by successful appeals to local district councils.

In the slowly emerging purely private stock, there are no rent controls. Rental agreements are set by lease and are usually for a fixed term. Disputes between landlords and tenants in private housing are typically handled directly by self-help measures because of cumbersome enforcement procedures and the overburdened judicial system.

Zoning and construction standards. Zoning is another area in need of clarification as being a very diffuse and inefficient pattern of land use. Currently, the land use system is in limbo. Old regulations are not necessarily being followed, no general land use framework has been set, and authority to regulate has not been vested fully in local governments. Although questions of title are being addressed, authority over zoning and building regulations has yet to be distributed among local actors. Currently this authority may be exercised by district or county governments, city planning departments, public utility authorities, county commissioners, or a number of central Ministries. Because owners are unsure from whom to seek necessary permits, they often attempt to secure permission from everyone—both those who currently appear to exercise authority and those who formerly did so.

Furthermore, not only is there a surfeit of potential regulatory authority in some areas, but there is a problematic lack of it in others. For example, some regulations needed by private real estate developers—such as regulations governing commercial scale residential, commercial, or industrial subdivision of undeveloped land—still do not exist. Nor is there an appropriate regulatory framework governing infrastructure needs and financing for private land development—for example, a framework that would permit exactions, special assessments or land readjustment. A 1991 modification of the Building Law does permit conversion to industrial uses of agricultural land at the urban fringe (usually the most dynamic area for commercial land development) upon payment of a transfer fine to a land protection fund, but the actual impact of such regulation needs to be tested. Rules for real estate brokers and for resolving property valuation disputes are not in place. Finally, building standards are governed by the 1990 National Building Code and the old 1986 Budapest city planning rules. A new Construction Law has yet to be written with affordable building standards for the types of buildings market systems are likely to demand.

In summary, a modern land use planning system with clearly defined procedures is required, one that offers wide discretion to the market, provides a dispute resolution mechanism that fairly balances interests of neighbors, developers, and city government, and forces development to internalize its environmental costs.

Rights to intellectual property

The legal framework for intellectual property protection in Hungary has generally been considered better than that available in other CEE countries. However, inadequate means for investigation and enforcement remain a problem, resulting in widespread piracy, mainly of software, music, and pharmaceuticals.

Patents

Hungary's current domestic legislation is the Patents Act No. II of 1969, Decree-Law No. 5 of 1983 on Patents, and Decree No. 28 of 1978 on the Protection of Industrial Designs. As with many western laws, these laws give an inventor exclusive rights over an invention[31] for 20 years from the date of application. Hungarian patent law prohibits certain inventions from being patented, including medicines and chemically fabricated products, food products, and "immoral" or illegal items. The Patent Office is planning to propose an amendment to the Patent Act to delete article 6(3) (excluding pharmaceuticals and chemicals from patentability) in order to harmonize the Act with the European norm and allow Hungary to apply for associate membership in the European Patent System. A complete revision of the Patent Act is expected to be presented by 1994.

The law also provides for "compulsory licences", by which the state can grant use rights to third parties if an invention has not been sufficiently utilized within three years of its being patented.[32] In this situation, parties may negotiate the

[31] Patentable inventions must be novel, meaning that the public must not have access to the design through the print media or common knowledge or practice.

[32] Compulsory licensing provisions are well-known throughout the world and are permitted under the Paris Convention, to which Hungary is a signatory party.

proper licensing fee, but if a fee cannot be agreed upon by the patentee and the license, it will be fixed by the court. Practically speaking, however, the compulsory licensing power is unlikely to be used much in practice, as compulsory licenses are often ineffective due to the user's likely need for the patent holder's technological expertise and cooperation.

Hungary has been a signatory to the Paris Convention for the Protection of Industrial Property (1883) since 1967. This is the major international treaty protecting patents and trademarks. The two most important rights granted by the treaty are national treatment of foreigners and right of priority in registration. The right to national treatment obligates countries to treat foreigners as they would their own nationals under their own laws. The right of priority gives the holder of a patent one year to file in other member countries without losing priority rights over other potential claimants to the invention. However, the criteria for patentability is still a question of domestic law. Thus, the Paris Convention would do little to protect patents without a Hungarian law that provided reliable substantive patent rights.

All patent applications are submitted to the National Patent Office, which conducts a formal examination of the application. The process takes approximately 18 months, normal by western standards. The application fee itself is nominal (HUF 1000–2000), as is the annual fee (HUF 6000) for the first five years. Thereafter, the fee grows incrementally, reaching HUF 24,000 in the 20th year. Decisions of the Patent Office may be appealed to the Metropolitan or Regional Court, and from there to the Supreme Court.

Trademarks

Trademarks in Hungary are protected by Act No. IX of 1969.[33] This law grants exclusive rights of use and transfer of registered trademarks for an initial period of 10 years, renewable for 10 year periods thereafter. Like patents, trademarks are to be registered at the Patent Office. Fees are HUF 3000 for the first ten years plus and additional HUF 1000 for international registration.

As a signatory to the Paris Convention, Hungary grants national treatment and right of priority to foreign trademark owners. Right of priority lasts six months for trademarks, as opposed to one year for patents. The Paris Convention does, however, provide a bit more substantive protection for trademarks than for patents by automatically protecting well-known marks, apparently without requiring that the mark be registered in other member countries.

[33] Effective as of July 1, 1970.

Hungary is also signatory to the most current text of the Madrid Agreement Concerning the International Registration of Marks (Stockholm, 1967). The Madrid Agreement protects both trademarks and service marks by allowing members of signatory countries to register their trademarks with the International Bureau of the World Intellectual Property Organization (WIPO) in Geneva. The mark must first be registered in the country of origin, whose administration applies for registration with WIPO. Registering with WIPO protects a mark in all signatory countries. Upon notification of WIPO registration, however, national administrations may still be authorized by national law to declare that certain trademark protection cannot be granted in that territory. Thus, like the Paris Convention, the Madrid Agreement depends ultimately on domestic law to protect substantive rights.

Copyright

The current Hungarian law providing copyright protection is the Hungarian Copyright Act No. III of 1969 (as amended in 1978, implemented by Decree No. 9 of July 12, 1983). This law is considered to be the most advanced of all CEE copyright laws, mainly because it contains some protection for computer programs (since 1983) and is generally consistent with European norms. In keeping with the commonly accepted language of copyright protection, this law protects "literary, scientific and artistic creations".[34] While such language in other countries is often interpreted not to include computer software, the implementing decree of July 12, 1983 explicitly includes "computer programs and the related documentation".[35]

Sound recordings are protected under Decree No. 19 of 1975 on the Protection of Producers of Phonograms. This protection grants producers the exclusive right to reproduce, distribute, or publicly perform the work in question but neglects the more important economic rights to commercial renting and lending. (*Schwartz* 1991) Furthermore, no criminal sanctions protect the rights that are granted in the decree.

Registration of copyrighted work is not required under Hungarian law. Upon creation works are protected. Generally, works are protected for 50 years after the death of the author.[36] Sound recordings, however, are protected for only 20 years.[37]

[34] Copyright Statute of 1979, as amended up to 1978, Chapter I, Article 1. A non-exhaustive list of protected works, similar to Art. 2(1) of the Berne Convention, appears in the Decree of the Minister of Culture of December 29, 1969 (as amended through August 24, 1988).

[35] Decree Concerning the Implementation of the Copyright Act No. III of 1969, Decree No. 9 of December 29, 1969, as amended up to July 12, 1983, Article 1. A related advance in this field is the recent Act on the Protection of the Topography of the Microelectronic Semiconductor Products.

[36] Act No. III of 1969, Art. 15.

[37] Decree Law of 1975, Art. 1. The international norm for such protection is 50 years.

Chapter V of the Copyright Act lays out certain restrictions on contracting with Hungarian authors or users. Such contracts must be made through intermediary agencies listed in Section 20 of the Implementation Decree.[38] One such agency is ARTISJUS, a governmental agency functioning as a performing rights society, a copyright licensing agency, and a copyright spokesman for the government. In addition, most copyright disputes are mediated by ARTISJUS, although they may be brought before the Metropolitan Court.

In cases of copyright infringement, civil remedies include injunctions, damages, fines, and possibly destruction of the offending material (Copyright Act, Chapter XIII, Arts 52–53). Under the Penal Code, infringements of Hungarian copyright law qualify as misdemeanors. Some observers advocate additional criminal sanctions in cases of willful infringement, as exist in most European countries. Such sanctions are expected to be included in an upcoming amendment to the Penal Code.[39]

Hungary has been a signatory to the Berne Convention, which protects literary, scientific, and artistic works, since 1922. It adheres to the most recent revision of the Berne Convention, the Paris text of 1971, which extends the period of protection from 25 to 50 years. Under Berne, no formalities are required to protect a work in other member countries. Whereas in the country of origin protection may depend on registration, no central registration exists for international protection; upon creation, works are protected. Hungary has also been a signatory to the Universal Copyright Convention since January 1971 (including the Paris Act, July 1974) and the Geneva Phonograms Convention since 1975.

Company law

Company law plays a central role in market economies. It sets guidelines for the internal organization of companies and for systems of corporate governance. Together with securities legislation, it tries to protect outside investors and the public by specifying minimum requirements for capital and for the publication of information about the company. It also tries to encourage entrepreneurship by setting limits to the liability of investors.

The idea of firm-level independence and autonomy is not an entirely new concept in Hungary. From 1875–1948, Hungary's company law had been developing in tandem with those of its western neighbors. For two decades after 1948 Hungary followed the classical model of centrally planned socialism. Then, in an attempt

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[38] Decree No. 9 of 1969, as amended up to July 12, 1983, Article 1.

[39] *Hungarian Economic Review*, October 1991, Appendix p. 24. The International Intellectual Property Alliance reports that as of Nov. 1990, criminal incarceration of up to three years is available for plagiarism causing material loss to the author. (IIPA 1990)

to move away from classical socialism toward a socialist market economy, Hungary adopted the New Economic Mechanism in 1968. As discussed earlier, the NEM delegated more decision-making to the enterprise level. Enterprises were still expected to meet their production targets under the state economic plan, but they were freer to make their own decisions regarding the means (including labor and investment needs) to meet those ends. Enterprise autonomy was first legally recognized in Act No. VI of 1977 on State-Owned Enterprises. The true landmark of enterprise management reform, however, appeared with the 1984 amendment to this act, Decree No. 22. The amended act introduced the concept of the self-managed enterprise, whose management could take one of two forms: the enterprise council (a representative body of employees) or the general assembly of employees. As a result of this law, approximately 80% of Hungary's enterprises became self-managed, while the remainder stayed under central state administrative control. (*Bokros* 1990)

In the late 1980s Hungary made a series of reforms designed to further its transformation to a market economy. Unlike Poland, it did not revive its prewar company law. Rather, Hungary used the opportunity to draft an entirely new code, the Act on Business Organizations, based upon German and Swiss models. As in other CEE countries, Hungarian company law serves companies being newly established as well as the "corporatization" of formerly state-owned enterprises.[40] The law recognizes a number of business forms of organization, including the joint stock company, the limited liability company,[41] and both ordinary and limited partnerships.

The joint stock company

In Hungary the joint stock company is often referred to as the "company limited by shares" or "corporation". It resembles the French societe anonyme (S.A.), the German Aktiengesellschaft (A.G.), and the American corporation. It is designated by the letters "Rt." in its name. This form is most appropriate for companies seeking a large number of shareholders and is the most conductive to public offerings.

Capitalization and disclosure requirements A joint stock company may be founded by one or more persons. Minimum capital is: HUF 10 million (approximately \$130,000), of which at least 30% must be paid in upon registration. Each

[40] Corporatization refers to the legal transformation of state owned enterprises into corporate forms set out in the Act on Business Organizations. The process by which this is accomplished is dictated by the Transformation Act (Act XIII of 1989 on the Conversion of Business Organizations now incorporated into the Company Law).

[41] The limited liability form had been available for use since 1930 but this was restricted to joint ventures with foreign participation. Decree of Minister of Finance 28 of 1972.

share must have a par value and the registered capital should be divisible by 10,000. The total amount of the par value of all shares constitutes the company's registered capital. The value of non-cash contributions may be included in the registered capital, if checked by an auditor and accepted and disclosed by the founders in a written declaration.

This form of company provides the most freely transferable vehicle for investment. Bearer shares are freely transferable,[42] as are registered shares (Sec. 240).[43] The form also offers the greatest flexibility in obtaining capital, although many of the financial instruments envisioned in the Company Act (as discussed below) are not yet used in practice, due in large part to a lack of familiarity by Hungarian investors.

A wide variety of classes of shares is authorized by the Company Act, although shares within the same class must have identical par value. Voting rights of different classes of shares may differ without limit, if so specified in the company's articles. While voting rights are generally proportional to share value, the articles may limit those rights.[44] *Preferred shares* may be issued that entitle the owner to priority in the distribution of dividends, although the total value of preferred shares may not exceed 50% of the company's registered capital (Sec. 242). Such preferred shares may carry limited or zero voting rights if so detailed in the company statute.[45] Companies may also issue *interest-bearing shares* (Sec. 245). This share is a modern hybrid, possessing characteristics of both debt and equity financing. Like debt, interest-bearing shares earn a rate of interest, as determined by the company articles, regardless of whether the company has shown a profit that year. Like equity, such shares may also be entitled to receive dividends. In light of the demands such financing may put on a company, these shares may total only 10% of the company's share capital. While this class of share has not been used much yet in practice, owners of interest-bearing shares are entitled to "the other rights attaching to the share (including the right to a dividend)" (Sec. 245), including voting rights. It would also be possible to structure preferred shares without voting rights to resemble interest-bearing shares.

Varied instruments of debt financing, including *convertible* and *preference bonds*, are also possible under the Company Act (Sec. 246), although the value of convertible bonds may not exceed 50% of the company's registered capital. A convertible bond entitles its holder to convert the bond into equity shares on terms

[42] Foreigners may posses only registered shares.

[43] Transfers of registered shares are governed by the rules regulating bills of exchange, Decree of the Minister of Justice No. 1/1965 (I.24.) on the Publication of the Regulations Concerning Bills of Exchange Law, Hungarian Rules of Law in Force, No. 19–20, p. 1142, Budapest.

[44] Compare the Polish company law, which places a maximum of 5 votes on any one share. See Gray et. al., *Poland*, supra note 2.

[45] If dividends due on preferred non-voting shares are not paid for two consecutive years, those shareholders are entitled to voting rights until those dividends are distributed.

detailed in the bond itself, which is favourable to the holder when dividends exceed the bond's interest payments. A preference bond entitles its holder to the option of buying a proportional number of new shares, should the company decide to issue them. Apparently such a bond may be exchanged for the new shares, but the rate of conversion is an open question.

Finally, *workers' shares* are envisioned by the Company Act (Sec. 244). These may be distributed to current employees free of charge or at a rate lower than the issuing or market price. Their total may not exceed 10% of the company's registered capital. The shares may be transferred to other workers and pensioners.

Rights and duties of shareholders. Shareholders are entitled to dividends in proportion to their share value, and, in the event of liquidation, to a proportional share of the company assets. The distribution of dividends is at the discretion of the directors, but dividends may not debit the registered capital. All shareholders may attend the general meetings, and those holding voting shares may vote in person or by proxy. A simple majority is needed to elect and recall members of the Board of Directors and the Supervisory Board, to approve the balance sheet and profit distribution, to permit the issuance of convertible or preference bonds. A three-fourths majority is needed to amend the Articles of Association, modify rights attached to a particular type of share, and merge, dissolve, or convert the company to another form. Because this three-fourths majority is required to make many key business decisions, in practice investors have generally sought this level of control when buying companies privatized through the State Property Agency.

The company law protects the rights of minority shareholders, defined as representing 10% of the shares (or a smaller percentage) if included in the company's articles. The minority rights protected include the right to call a general meeting, to place a specific item on the meeting's agenda,[46] and to request the supervisory board to examine management's activity. (Sections 273–275) Any shareholder, member of management, or member of the supervisory board may appeal to the Court any decision of the general assembly thought to infringe the Company Law, the articles of association, or any other law.[47]

Corporate governance. All joint stock companies in Hungary must have the Board of Directors for management, and the Supervisory Board for controlling the management. In addition, an outside auditor is always required. Executive officers are employees who may be appointed for a definite or indefinite period by the Board of Directors. The members of the Board of Directors are elected and dismissed by the shareholders and are held to a general duty of care defined by the Civil Code, principles of officer and director liability are not yet well-developed.

[46] These shareholders must hold voting shares. Also, if these two requests are not honored, the Court of Registration has the authority to enforce the requests.

[47] Section 276. The shareholder may not have voted for that decision. Exceptions to this are error, fraud, or threat.

The Board of Directors must consist of between 3 and 11 members. Conflict of interest provisions attempt to prevent members of the Board from concluding in their own names transactions similar to that of the company, being a partner with unlimited liability in any company similar to this company, and being a leading official in similar companies. (Section 280)

The Supervisory Board is charged with overseeing the activity of the Board of Directors. It must consist minimum 3 members, who may be elected from either among the shareholders or from outside. If the company employs on annual average 200 employees, one-third of the supervisory board must be elected by the employees.

The limited liability company

The limited liability company form resembles the German GmbH and the French s.a.r.l. It is identified by the letters "Kft." or "Ltd." appearing after its name. As in other CEE countries, this form of company is more popular than the joint stock company among Hungarian investors because of its simpler structure and lower capital requirements. Many larger foreign investors, in contrast, choose the joint stock form because of the greater ability to tailor share structure and voting and other rules to their particular needs. The limited liability company is primarily intended as an investment vehicle for a relatively small group of investors who know and deal with each other on a regular basis. During the first quarter of 1992, 2507 limited liability companies registered in the Budapest Court of Registration.

Capitalization. A limited liability company may be founded by one or more persons, apparently with no maximum limit.[48] Its minimum capital must be HUF one million (approximately $13,000). This capital is divided into quotas of a predetermined amount. Each quota must be at least HUF 100,000 and exactly divisible by 10,000 (Section 159). Parties holding a quota in the company are referred to as members. One quota may be held by several individuals, who together are deemed to be one member, who exercise their rights through a common representative, and who are jointly liable for the obligations of the members. Each member may hold no more than one quota but the value of that quota may increase (or decrease) in proportion to his or her contribution (Section 169). Contributions may be either cash or in-kind. Upon foundation of the company, at least 30% of the initial capital (but not be less than HUF 500,000) and at least 50% of each quota must be paid in, (Section 160) the rest payable within 1 year. Members' quotas are freely transferable to any other member of the LLC, but before being sold to outsiders

[48]Some other European countries impose a maximum limit (such as 50) on the number of partners in this form of company in order to differentiate it more clearly from the joint stock form and force conversion to the latter form (with its stricter capital and information requirements) as the company grows in size.

they must be offered to other members, the company, or someone chosen by the membership.[49] These requirements are absolute, and the contract of association may not stipulate more favorable terms. Unlike the joint stock company, the limited liability company may not recruit members through public solicitation (Section 156).

Rights and duties of members. Members are entitled to dividends and, in the event of liquidation, assets in proportion to the size of their quota. Voting rights are determined by the size of each quota; each HUF 10,000 unit entitles its holder to one vote. Thus, each member has at least 10 votes, but variations above this minimum may be determined by the contract of association. Apart from the obligation to pay in one's primary quota members bear no liability for the LLC's debts.

Members must hold meetings at least once a year. Decisions are passed by simple majority unless otherwise stipulated in the contract of association. However, members may pass decisions by mail without holding a meeting, subject to the normal requirements for voting majorities, unless any member requests a meeting be convened to discuss the decision. Minority members (i.e. members representing at least 10% of the current registered capital) may call a meeting of all members. (Section 190) As with the joint stock company, any amendment to the company's contract of association requires a three-fourths vote.

Company governance. The LLC may be managed by one or more directors or managers, elected by members representing a majority of the company's assigned votes to serve for terms of 5 years, renewable. A Supervisory Board with at least 3 members is mandatory for the LLC only if its capital exceeds HUF 20 million, the members exceed 25, or the annual average number of employees exceeds 200. In the latter case, one-third of the members of the supervisory board must be elected by the employees as with the joint stock company. (Section 13(1–2)) An independent auditor is required if the company's initial capital is greater than HUF 50 million, or if the company is held by one person.

Partnership forms

Two common forms of partnership are included in the Company Act, the ordinary partnership and the limited partnership. In the ordinary partnership, all partners are jointly and severally liable for the partnership's liabilities. (Section 55) The limited partnership consists of limited partners, whose liability is limited to their contribution to the partnership, and at least one general partner, who is

[49]Section 171. This is different from the stricter rule found in some other European countries that a stake cannot be sold to outsiders without the express and unanimous permission of insiders. What constitutes a valid offer in the LLC case is based on the contract of association of the LLC.

responsible for actively managing the company and whose liability is unlimited.[50] Both forms are quite flexible, as partners are able to negotiate their own arrangements concerning capital contributions, distribution of profits and losses, and allocation of voting and managerial rights. As is common in CEE countries (with the exception of Poland), Hungarian partnerships are not pass-through entities and are thus subject to tax at the entity level.

Procedures for setting up a company

The first step in setting up either a joint stock company or a limited liability company is drafting the Articles of Association or Contract of Association, which must be signed by all the founding members and an attorney (Section 19). Although the Articles must be notarized, this procedure is not so expensive or time-consuming as in some other CEE countries,[51] because the job of notaries is not to approve the form of the documents, but merely to certify that the signatures are authentic.

Within 30 days of the Articles being adopted, the company must apply to the Court of Registration to register the company (Section 23). Included in its application must be a registration fee equalling 2% of the company's initial capital and a certification from the bank that the necessary part of the initial capital is on deposit. This step is known to be slow—taking on average about 6 months—and cumbersome, although the Court of Registration is now fully computerized. The delay is caused by the enormous backlog of applications, mistakes generated by the relative inexperience of lawyers filing registrations, and careful court scrutiny of each application for conformity to Company Act requirements. If some provisions do not comply with the Act's formal requirements, the Court may return the Articles for changes.

The company attains legal personality upon its registration in the Trade Register (Section 24). It may then access its bank deposit and formally begin its activities. In addition, it may then ratify any actions taken by the founders between the period the articles were adopted and the company registered.

[50] In an apparent effort to protect creditors, the Company Act limits natural persons to membership in one business organization in which he or she carries unlimited liability. Section 6.

[51] See, for example, Gray et. al., *Poland*, supra note 2.

Foreign investment law

Since Hungary opened its doors to foreign investment in 1988, the country has enjoyed a level of foreign investment unmatched by any other CEE country.[52] This was initially due to Hungary's original foreign investment law, Act XXIV of 1988, which was the most liberal investment law in the region at that time. The law has been modified periodically since then, but it still retains the basic features that are attractive to foreign investors.

Ownership and forms of investment

The law allows foreign individuals and entities to own up to 100% of a Hungarian investment, including the real property associated with it. The forms for such investment are governed by the Law on Business Organisations discussed above and include both incorporated firms and branches. No special permission is needed.[53] In the event of expropriation, the law guarantees foreign investors full compensation in the currency of the original investment, at market conditions.

Profit repatriation

While the Hungarian forint is not yet formally convertible, the foreign investment law does allow foreign investors to repatriate their forint profits[54] in the currency of the original investment (at the official exchange rate[55]), "provided the company has the equivalent amount in forint on reserve".[56]

[52] As of late May, 1991, Hungary had $1.2 billion in foreign capital (over half the total foreign capital in all of Eastern Europe) invested in 5000 joint ventures. Germany and Austria are partners in approximately 2000 of these ventures, and approximately 40% of this $1.2 billion comes from U.S. investment (fewer in number but typically larger in size). Most joint ventures are small service and/or trade operations, employing only one or two people. Around one half of all joint ventures consist of $160,000 or less. (Okolicsanyi 1991)

[53] A previous requirement that the Minister of Finance and the Minister of Commerce approve foreign ownership exceeding 50% was repealed in 1990. Act XCVIII of 1990, Sec.1.

[54] The foreign investor is also entitled to this repatriation right if the company is liquidated or the foreign investor sells his interest. Additionally, 50% of the taxed personal income of foreign managerial employees may be fully repatriated.

[55] Details regarding foreign exchange rights are covered under the Planned Foreign Exchange Policy, Law-decree No. 1 of 1974 concerning planned foreign exchange policy (as amended through 7/2/1990); translated in Hungarian Rules of Law in Force I./Nr. 12.

[56] Act XXIV of 1988 on Foreign Investment, para. 32(1); see also Company Act para. 9(1).

Foreign individuals and companies with foreign participation are permitted to maintain hard currency accounts in any Hungarian commercial bank. Hungarian companies receiving capital contributions from foreigners in hard currency may also deposit them in such accounts.[57]

Tax and customs incentives

Hungary's corporate tax rate is currently 40%, but the foreign investment law offers generous tax incentives to foreign investors forming joint ventures until 31 December, 1993. These incentives are industry specific and depend upon the amount of foreign investment.[58] An annex to the Foreign Investment Law identifies areas of particular importance to the Hungarian economy.[59] If more than 50% of a company's sales revenue is derived from these activities, the founding capital exceeds 50 million forints, and the foreign contribution is at least 30%, the company receives a 100% tax holiday for the first five years, followed by a 60% holiday for the second five years. Other sectors receive smaller tax benefits. For example, companies building or operating a new hotel[60] with founding capital above 50 million forint and with at least 30% foreign contribution receive a 60% tax holiday for the first five years and a 40% holiday for the second five years. In addition, taxes are rebated on profits reinvested by the foreign partner in Hungary.

On the customs side, foreign investors importing capital equipment will not be charged customs duties if 1) the equipment is part of the foreign investor's contribution i.e. the registered capital of the company, or 2) it is paid for out of the company's hard currency account. If, however, during the subsequent three years the company sells or leases that equipment, then the company must pay the customs duty applicable at the time of importation. Customs free zones for foreign investors are also envisioned by the act. Companies incorporated in these zones will be exempt from Hungarian customs, excise, and exchange control regulations, as well as price controls and state supervisory regulations. They may maintain accounting systems in fully convertible currencies. Companies seeking to incorporate in such zones must obtain approval of the Ministry of Finance. Customs free companies have already been established in certain industries, with special rules on how the

[57] Act XXIV of 1988 on Foreign Investment, para. 32(1); see also Company Act para. 9(1).

[58] Earlier version of this law granted an automatic 20% tax cut for companies with either foreign equity of at least 20% or HUF 5 million.

[59] These include electronics, car parts, machinery, engineering units, pharmaceuticals, packaging technology, agricultural and food technology, energy conservation, telecommunications, tourism, and public transportation.

[60] The hotels covered by this section include not only those constructed by the company in question (Para. 15 (2)(a)), but also renovations that classify a building as a hotel or that upgrade a preexisting hotel to a higher classification (Para. 15 (3)(b)).

plant is built and operated—requiring security fences, guards, and documents—to segregate customs-free goods.

The generous tax incentives offered to foreign investors in Hungary have been widely criticized by economists and tax policy experts. Not only do they discriminate against domestic investment, but tax incentives—holidays, in particular—can cause tremendous revenue loss and severely complicate tax administration. Recognizing these problems, Hungary has moved recently to eliminate these special tax incentives for foreign investments. They are to last for a maximum of 10 years and be available only to companies that are substantially in production before the end of 1993.

Dispute resolution

The Hungarian foreign investment regime gives substantial freedom to private investors to choose the mode and venue for purposes of dispute resolution using arbitration. At present approximately half of all disputes are arbitrated through the Hungarian Chamber of Commerce, and about half in other international forums. Apart from the Articles of Association, which must be governed by Hungarian law, any other agreement related to the setting up or operation of a joint venture may be governed by foreign law if the parties so choose.[61]

Hungary has been a signatory to the International Convention for Settlement of Investment Disputes since October 1986. This Convention guarantees a forum in which private citizens of signatory states may arbitrate against governments of other signatory states.

Contract law

The ability to contract freely with others and the assurance that contracts will be enforced are among the most basic requirements of the Hungarian Civil Code.

Contracts under socialist law

Contract law in Hungary, as in all of its European neighbors, has been broadly governed since 1959 by the Civil Code and more specifically by companion laws and implementing regulations and decrees. Two distinct spheres of contractual

[61] For example, Swiss law is commonly chosen to govern shareholders' agreements.

relations existed during the socialist period: the private and the commercial or "economic". The private sphere consisted mainly of personal agreements among individuals, usually for small monetary amounts or equivalents. For these contracts, Civil Code was and still is adequate to set a framework for bargaining and to resolve any disputes that may arise. Contracts between citizens, or between citizens and economic organizations, did not differ essentially from similar contracts in western market economies, although their scope was influenced by the economic policies of the state—most importantly the restrictions on ownership of private property and the means of production.

More significant for Hungary's economy the "economic" contracts. These refer to contracts between state enterprises that were instruments of the state economic plan. Because state-owned enterprises were expected to fulfill their production quotas under the state plan, and because the socialist industrial base existed primarily of monopolistic suppliers, state-owned enterprises had little choice regarding with whom and to what extent they contracted. Thus, inter-enterprise agreements were in essence translations of plan targets into contractual form.

The primacy of the plan led to certain aspects of contract law unique to socialist systems. For example, there arose a "duty to contract". Although this duty originally applied to specific plan targets, it seemed to develop into a general duty to conclude economic contracts, even when the contract was not part of the plan. This duty was actionable, meaning that anyone who breached it could be formally challenged in a "precontractual arbitration". (Para. 208)

Like Poland, but unlike Romania,[62] Hungary did specifically incorporate socialist principles into its Civil Code. Thus, the civil code allowed for mandatory conclusions of contracts by statute or ministerial decree (Para. 198); nullification of contracts injurious to socialist norms (Para. 200); modification and conclusion of contracts by the courts to further national economic interests (Para. 206); and definition of the contents of contracts (such as prices) by legal rule (as determined by state arbitration), regardless of the wishes of the parties (Para. 226).

Until the 1970s, disputes resulting from socialist contracts were usually withdrawn from the jurisdiction of the courts and relegated to so-called "economic arbitration tribunals" which functioned more as administrators of the state plan than impartial jurists.[63] Because contracts were designed to implement the central plan and because of the scarcity and monopolization of most resources, the preferred form of remedy in case of breach was specific performance. In contrast,

[62] See Gray et al, *Poland* and *Romania*, supra note 2. Poland's Civil Code was drafted in 1964, during the socialist period, while Romania's Code dates from prewar times and was never amended during the socialist period. The same socialist contract rules existed in Romania, however, but with a different legal base.

[63] Government Decree No. 51 of 1955 (VIII.19). This mechanism was abolished in the early 1970s, after which inter-enterprise disputes were heard by the county courts (discussed below under Judiciary).

monetary damages tend to be the preferred remedy in a market economy, where the damaged party can typically reenter the market and negotiate another contract for those goods or services.[64] In socialist economies there was often no other supplier or purchaser to which the injured party could turn. Furthermore, determining the proper level of damages would not be as straightforward given the absence of market signals.

Compared to other CEE countries, Hungary's industrial sector is generally thought to have enjoyed relatively greater freedom of contract during the socialist period. Much of this was due to management reform under the New Economic Mechanism of 1968, which shifted more decision-making power from the Ministerial level to the enterprises. Act IV of 1977 significantly modified Hungary's contract law by reintroducing the concept of freedom of contract into the commercial sphere. While management did enjoy greater independence after the reforms of the late 1960s and 1970s, enterprise output was still expected to meet the goals set by the national economic plan. Moreover, freedom of contract continued to be limited by the scarcity of both economic resources and credits. Thus, freedom of contract was substantially increased but still did not approach that found in western market economies. To this day, many transactions remain governed by the Contract for Delivery of Merchandise (Paras. 379–386) which include many obsolete administrative requirements and restrictions.[65]

Current status

Commercial transactions in the economy are increasingly being conducted according to the sections of the Civil Code originally designed for small, noncommercial private transactions. These sections embody standard western contract concepts. They incorporate basic principles of offer, acceptance, and performance. They provide standard terms for about 25 types of transactions, such as sales contracts and real estate leases. (Ostas 1992) They also provide legal doctrine to govern usurious interest rates, bad faith dealing, illegal contracts, mistake, deception, duress, capacity, and impossibility of performance.

Court interpretations and decisions over the coming years will determine the true substance of contract law in Hungary and just how far "freedom of contract" extends, particularly when it collides with other social concerns.

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[64] In the interests of efficiency, western contract law allows parties to breach contracts when that will prove to be in their economic interest.

[65] Government Decree No. 7 of 1978 (II.1).

Bankruptcy[66]

Bankruptcy law serves several related functions in a market economy. First, it provides a mechanism to liquidate inviable enterprises and repay creditor's claims according to some pre-established rules of priority. Second, in cases of default in which some or all of the operations of the debtor are potentially viable, it provides a legal framework through which creditors and debtors can negotiate binding agreements to undertake financial and real reorganization. In most cases such reorganization includes partial liquidation—i.e. the sale of some of the debtors' assets. Third, the threat of bankruptcy imposes greater financial discipline on enterprise managers. Hence, bankruptcy laws are important promoters of industrial restructuring.

It is important to distinguish between two different sets of potential "users" of bankruptcy procedures. The first is the large group of state-owned enterprises that are inefficient and in need of restructuring or liquidation. For these state-owned firms, bankruptcy procedures and the threat of liquidation[67] are thought to provide the motivation to restructure that might not otherwise exist, in part due to the pro-labor incentives caused by extensive worker self-management.[68] The second group is the newly emerging private sector, whether enterprises or banks. For this group, bankruptcy law is part of a wider set of legal rules—which also includes provisions defining legally-enforceable security interests and methods of foreclosure—that increases the potential for debt collection and thus facilitates the flow of private credit in an economy. Such credit is essential for the success of new private business.

Thus serving two "masters", bankruptcy law is seriously overburdened in Hungary and other CEE countries. The reorganization and liquidation procedures are to play a major role in the solution of the systemic problems of enterprises and

[66] The authors are heavily indebted to Izak *Atiyas* for his extensive substantive input into this section.

[67] Creditor passivity in initiating bankruptcy cases has been common in CEE countries, in part because state-owned banks themselves faced "soft budget contraints" and could in essence count on bail-outs from the government if enterprise debts were in arrears. To counter creditor passivity, the Hungarian government mobilized the tax and social security authorities to initiate liquidation proceedings against enterprises which were in arrears in their tax or social security payments. The effect of this initiative was limited, because enterprises started to pay their tax and social security obligations to avoid liquidation. With a similar purpose, the liquidation law was amended to require enterprise management to file for liquidation whenever a situation of default persisted for a certain period of time, a measure that has been dubbed self-bankruptcy.

[68] Many Hungarian state enterprises are "self-managed", i.e. managed by enterprise councils (if employment is over 500) or by enterprise assemblies (if employment is less than 500). In those enterprises, restructuring or liquidation can take place only with the consent of enterprise councils or assemblies. Even though there are exceptions, the managements of these enterprises are widely believed to be unwilling to adopt restructuring policies that may result in unemployment or indeed loss of control.

banks carried over from socialism. This may be more than can be asked of a judicial procedure; these systemic problems may instead require systemic solutions outside of bankruptcy proper. In most market economies, in contrast, the bankruptcy process works at the margin for the relatively few firms that cannot make it in an otherwise healthy economy. Such a role is important to the second "audience" in the CEE countries—the newly emerging private sector.

The new bankruptcy law

The Law on Bankruptcy Procedures, Liquidation Procedures and Final Settlement was passed by Parliament in September, 1991. It provides two alternative avenues for defaulting debtors—reorganization and liquidation. The first avenue, reorganization (or "bankruptcy" in the official Hungarian translation), did not exist under previous law and is similar in purpose to Chapter 11 of the U.S. Bankruptcy Code. It is a workout-oriented procedure designed to allow the debtor to achieve a settlement with creditors and continue in operation. The debtor may file for reorganization if it expects that it will otherwise be forced to default on its debts within a year, or if it is already insolvent but its creditors have not yet initiated liquidation. The debtor is indeed obligated under the new law to file for bankruptcy (i.e., reorganization or liquidation) if it is more than 90 days in default.

During reorganization, the current management remains in control of the debtor's assets. After the announcement of the bankruptcy procedure, the debtor is entitled to a 90-day moratorium on monetary claims (other than wages) that have become due. Within 60 days it must prepare a proposal for reorganization to restore solvency, which must then be approved by all creditors present at the hearing called for such purpose.[69] If the proposal is approved, the court declares the bankruptcy procedure concluded within 15 days.

The second procedure, liquidation, can be initiated by the debtor itself or by a creditor.[70] In addition, a reorganization procedure automatically becomes a liquidation one if the debtor and the creditors fail to reach agreement within 90 days. During liquidation, the debtor's assets are managed by a trustee, who is charged with liquidating the debtor's assets and repaying creditors. However, the debtor may still try to reach a settlement with its creditors during liquidation. If such a settlement is reached, the liquidation procedure is suspended. A settlement is approved only if accepted by half of the creditors entitled to vote in each class of

[69]Bankruptcy laws in most countries do not seek unanimous agreement for the approval of an agreement. In that respect, the Hungarian law is stricter.

[70]This includes banks, suppliers, and the social security fund. Until 1991, suppliers were the most active in petitioning for relief against debtors; of 528 petitions in that year, only 8 were from banks and 5 from the social security fund.

creditors, and by creditors representing at least two-thirds of the total claims. The law also contains a "simplified" liquidation procedure for cases where the value of the debtor's assets are insufficient to cover even the costs of liquidation proceedings. In such case assets themselves may be distributed to the creditors.

The new law is different from the previous one in several important respects. First, it establishes time limits on the different stages of the bankruptcy and liquidation process in order to speed up the process. For example, following a petition, the court is required to determine whether to initiate a bankruptcy procedure within 15 days (Section 12), an action that under the old system took up to several months. In the case of petitions for liquidation, the court has to establish the presence or absence of a default within 90 days (Section 27). As noted earlier, there are strict time limits on the preparation and negotiation of a reorganization agreement. The new law also imposes a maximum of two years for the competition of liquidation.

Second, the law tries carefully to balance the distribution of control over assets and of bargaining power between debtor and creditors. As indicated above, the management of the debtor enterprise effectively retains control and therefore has significant bargaining power during negotiations for a settlement. However, two provisions are introduced to protect creditors. First, creditors may request the court to appoint a "property supervisor", who has no management powers but nevertheless oversees the financial situation and asset management of the company to protect creditors' rights. Second, the automatic transformation of reorganization into liquidation (Art. 21) in case a settlement is not reached inhibits the debtor's managers from delaying the process or adopting an unduly tough position during negotiations.

Third, the new law encourages reorganization in lieu of liquidation when feasible, and it tries to encourage real as well as financial restructuring to make surviving firms more competitive in the longer-run. The restructuring agreement is required to contain "measures likely to result in the increase of incomes" (Art. 18,1.a). Moreover, the law explicitly mentions that "within the framework of the agreement...creditors or third parties may secure ownership rights in the property of the debtor" (Art. 17). Both provisions increase the likelihood that agreements address not only financial but also real restructuring. The creditors are also allowed to designate persons to monitor the debtor's compliance with the agreement. The ability to monitor increases creditors' confidence in agreements and therefore encourages reorganization.

Despite these positive aspects, however, there are a few where the current law may benefit from further improvements. An important drawback of the law has to do with the priority among claims upon liquidation. Specifically, the claims of creditors secured by liens on assets have lower priority than claims for wages and severance payments, which are considered to be liquidation costs. This provision—a political compromise and a deviation from the international norm although a development concerning the old law—is likely to dampen the incentives of secured creditors to initiate bankruptcy, to reduce the role of banks in enterprise restructuring, and to constrain the development of secured credit as a financial instrument.

In addition, the rights of dissenting secured creditors in a settlement arranged between creditors and the debtor during the process of liquidation need to be further clarified.[71] In particular, it is not clear whether a dissenting secured creditor retains the right to exercise its security or whether an agreement can reduce its claims without its prior consent.[72]

The law in practice

The number of bankruptcy filings has skyrocketed under the new law. The number of filings increased from 528 in 1991[73] to 14,300 (4,400 as reorganizations and 9900 as liquidations) in 1992.[74] Because the law came into effect January 1, 1992 and requires reporting after 90 days in default, there was a particular surge of 3540 filings in April—including 2259 reorganization filings and 1281 liquidation filings.

The strong pace of filings is expected to continue for several reasons. First, new banking and accounting laws are expected to put pressure on the banking system and make banks more vigilant on debt collection. Second, the new law is likely to make creditors more willing to initiate bankruptcy, both because liquidations should be faster and because the new law is more protective of creditors' rights. Third, enterprise managers are more likely to initiate bankruptcy under the new regime, because they are subject to penal sanctions if they willingly fail to do so when the enterprise is insolvent. Furthermore, they may be more willing to initiate

[71] This problem would not arise for settlements reached during reorganization because these agreements require the unanimous consent of all creditors. Therefore, any dissenting creditor would be able to block a proposed settlement.

[72] For example, consider a secured creditor whose claim is reduced in a proposed agreement and who does not consent to the settlement. Does that creditor retain the right to execute the security? Can a settlement remove a security without the consent of the creditor? The law does not provide clear answers to these questions. Different countries have resolved this issue in different ways. In some countries (such as Germany) the claims of secured creditors cannot be reduced in a settlement. In the U.S., a settlement can be approved despite dissenting creditors if the court decides that the dissenting creditors are treated "fairly and equitably", which for secured creditors means that they keep their liens on assets and they get periodic cash payments equal to the value of their claims. In the U.K., a settlement cannot be approved if it affects the rights of a secured creditor to enforce the security.

[73] These are filings for liquidations under the old law. (Mizsei 1992)

[74] Although the number of filings is monitored, data are not systematically kept on the nature and size of companies that enter reorganization or liquidation, or on the duration or ultimate disposition of the proceedings.

bankruptcy because of the possibility of reorganization (and retention of their jobs) in lieu of liquidation.

This surge in cases demonstrates the difficulty of applying the traditional solution—judicial bankruptcy proceedings—to the systemic problems of enterprise insolvency in CEE countries. It is highly improbable that *any* judicial system—much less one with relatively little exposure to economic matters—could handle such a surge in caseload efficiently and effectively. As noted earlier, the judicial route works best at the margin, but other means may be needed to handle the large systemic problems, which could affect 30–50 percent of the economy.[75] Not only are experienced judges in short supply, but so are qualified trustees. Especially in cases that involve large enterprises, liquidators have to act as corporate managers and financial managers in order to preserve the assets of the enterprise and, whenever viable, to encourage settlements between creditors and debtors. They also need to have legal expertise.[76] The Ministry of Finance has recently increased the pool of liquidators by establishing objective criteria for eligibility and selecting 90 additional liquidators from among numerous applicants. That is, however, still a small number for the thousands of cases now being filed.

Competition law

The structure and dominance of the public sector throughout Central and Eastern Europe is now proving to be an obstacle not only for the development of the private sector, but also for the improvement of the performance of the public sector itself. Large state-owned monopolies are able to impose unfair conditions on private firms, smaller public firms, and consumers. In essence, private firms are free to thrive primarily in niches not dominated by the state sector. Because of their power over output and jobs, large state firms act as a powerful lobby to influence government decision making in fiscal, monetary, trade, and other areas. For this reason the breakup and privatization of state monopolies is essential not only to the growth of a private sector but more generally to the development of a stable market economy. Competition law can be an important tool to encourage such breakup and to prevent abusive monopolistic behaviour. However, Hungary should

[75] For example, integrated programs of bank restructuring, enterprise restructuring, privatization, and liquidation of insolvent state-owned firms—primarily using non-judicial means—are now under discussion, for example, in Poland and Slovenia.

[76] The government is authorized to establish a list of liquidators. Until recently the supply of liquidators was provided by six institutions, most of them consulting firms. However, under Government Decree No 165/1991, individuals can also be included in the list of liquidators. Such individuals need to have a degree in economics, finance or law. Organizations that employ such individuals may also be enlisted. Applications are judged by a committee appointed by the Minister of Finance and Minister of Justice.

move very carefully in applying its competition law in order to avoid overzealous enforcement and resulting bureaucratic dampening of healthy competition.

Hungary's new competition law is Act LXXXVI of 1990 on the Prohibition of Unfair Market Practices,[77] which took effect on January 1, 1991. The law deals with the traditional areas of antimonopoly enforcement, including horizontal and vertical agreements among firms, abuse by a single firm of a dominant position, and merger control, and it sets up a specialized antimonopoly office, the Office of Economic Competition, to enforce these provisions (subject to review upon appeal by the Budapest district court).[78] The law also covers unfair competition and prohibits such activities as misleading advertising or "unfair" acquisition and use of business secrets.

On the topic of horizontal agreements, the law explicitly forbids agreements among competitors concerning such things as price, market division, technological development, or exclusion of certain consumers or input suppliers (Para. 14). However, the approach is a "rule of reason" one rather than the "per se" ban on horizontal cartel arrangements,[79] as there are numerous exceptions to the prohibiton, both specific (such as agreements between parties with less than 10 percent of the market) and general (for example, if such agreements are "aimed at stopping abuses of economic superiority" or if "the advantages exceed the disadvantages") (Paras. 15–17). Thus the law provides a relatively weak restriction and gives the antimonopoly office and the courts wide discretion in reviewing cases. While this discretion might help the authorities concentrate scarce administrative resources on certain cases, it weakens the general deterrence power of the law and could lead to long drawn-out arguments on what is or is not a limitation of competition. Hungary might want to consider strengthening the prohibition of horizontal cartel agreements by adopting a "per se" approach.[80]

In the area of vertical agreements, a separate section of the law forbids abuse of a "dominant"[81] position (Para. 20) and includes certain restrictions on vertical agreements. Para. 9 prohibits vertical tying arrangements regardless of the size of the firms involved. It is wise of Hungary to limit its scrutiny of vertical restrictions

[77] Hungary's concern with rules of competition actually began in the late 1960s, with its moves toward decentralized market socialism. As part of the reforms instituted under the New Economic Mechanism (1968), Hungary revitalized its original Act on Unfair Economic Competition (Act No. V on the Prohibition of Unfair Competition of 1923) through numerous governmental decrees. These rules were updated in 1984 with the adoption of Act No. IV on the Prohibition of Unfair Business Activities.

[78] Claims concerning unfair competition can be brought only to the court, while those concerning freedom and fairness of competition or consumer fraud can be brought to either the court or the Office of Competition.

[79] The merits of each case are considered on an individual basis under a "rule of reason" approach, while a "per se" approach forbids a particular practice under any circumstances.

[80] The same is argued in *Pittman* (1991).

[81] A dominant firm is defined as one having over 30 percent market share.

to those involving dominant firms, and the same rule should probably apply to tying arrangements. Economic analysis in the U.S. and Europe shows that many vertical restraints (such as resale price maintenance, refusals to deal, discriminatory pricing, and tying of sales) may enhance efficiency under certain circumstances—typically when market structure is competitive and the firms imposing the restraints are not in a dominant position.[82]

Also included in the section on dominant firms is any behaviour that limits access to the market to new entrants. (Article 20) This is extremely important in the Hungarian context if new private firms are to gain access to inputs and distribution networks. However, the Hungarians must be careful not to interpret reasonable market behaviour—such as buying in bulk, requiring up-front deposits from purchasers, or raising or lowering prices to consumers—as anticompetitive. In general enforcers should refrain from imposing direct price conditions, concentrating more on conditions of access to the market.

With regard to market structure, the Hungarian law empowers the antimonopoly office to review proposed mergers of large firms[83] and block any that are deemed anticompetitive. (Article 24) As with horizontal agreements, there are exceptions to the rule; mergers need not be blocked, for example, if the advantages to competition exceed the disadvantages, or if the merger promotes penetration into foreign markets. Again, the agency is given almost unlimited discretion.

One important element missing from the law is authority of the antimonopoly office to order the break-up of large monopolistic firms. Such authority should exist, particularly in the case of state-owned enterprises being privatized. Such a link between antimonopoly policy and privatization exists in both Poland and Czechoslovakia and is a useful tool to inhibit the privatization of public monopolies into private ones (which are certainly much harder to control or break-up once in private hands).

Interpreting and applying the new Hungarian law effectively is an enormous challenge, particularly given the discretion granted enforcement authorities in the law itself and the broader set of problems with antimonopoly legislation in general. *The enforcement office will need to tread lightly at first.* As well as handling individual complaints, it should concentrate on its other important missions: educating the public about the distortions caused by monopoly behaviour and lobbying the

[82] As a result of this economic analysis, enforcement of U.S. antitrust law has softened in the 1980s, and the department of Justice refuses to prosecute many cases it would have brought in earlier times. The OECD is also recommending that European jurisdictions relax their laws to look at each case of vertical restraint on a rule of reason rather than a per se basis. Opponents of the rule of reason approach argue that business need certainty above all, and that the rule of reason approach leaves too much uncertainty as to what is permitted and what is not, and therefore inhibits business activity.

[83] Firms must prenotify the office if they jointly have 30 percent market share or if their joint turnover in the previous year exceeded HUF 10 billion. Article 23.

government and Parliament to minimize barriers to international trade—the most powerful antimonopoly force of all.

Judicial institutions

Court structure

There are three levels of ordinary courts in the Hungarian judicial system: the Supreme Court, county courts, local courts, and the special courts.[84] Nationwide there are about 2000 judges, with about 200 unfilled positions. Most cases are brought initially in the local courts, of which there are 102. They are courts of general jurisdiction and hear criminal, civil, and commercial cases. Hungary has a fairly unified court system with few separate specialized courts, except for the Labor Court, the Court of Registration and the Military Court. The Court of Arbitration attached to the Hungarian Chamber of Commerce is not part of the court system.

Appeals from the local courts are to the county courts. There are nineteen county courts in Hungary, as well as the municipal court, which serves the Budapest metropolitan area. This level is divided into three branches: civil, commercial, and criminal. The Budapest municipal court has a separate labor chamber. A county court may act as the court of first instance when the amount in controversy exceeds HUF 3 million—typically disputes between state-owned enterprises[85]—or in claims related to intellectual property, libel, slander, damages caused by state officials, and certain other matters. In such cases, appeal may be made to the Supreme Court. The Supreme Court also guides lower courts by issuing advisory opinions. This judicial guidance role is stipulated in the Constitution. (Ch. I, sec. 47)

[84] The structure of the judiciary is defined by the current Constitution; Act IV of 1972 on the judiciary; Act LXXX of 1990 on the Establishment of Local Courts; Act XXXII of 1989 on the Establishment of the Constitutional Court; Act III of 1952 on the Code of Civil Procedure; and Act I of 1973 on Criminal Procedure, as amended. Law Decree 23 of 1989 and Executive Decree of the Minister of Justice govern courts of registration and registration of companies. The 1989 amendment to the Constitution introduced into this system a Constitutional Court (as discussed above), but it is not formally part of the judicial structure.

[85] Until 1972, all inter-enterprise disputes were heard by "economic arbitration tribunals", which settled supply and delivery agreements according to the state plan. These tribunals were abolished in the 1970s, and inter-enterprise disputes have since been heard by the commercial chambers of the county courts.

Changes in court organization began in 1989.[86] In 1990 a new law on the promotion and compensation of judges came into effect. Self-governing Judicial Councils were established to appoint court officials and to handle internal disciplinary cases. The latest amendment, Act LXVII of 1991, increases the role of Judicial Councils in court financial decisions and in selection and appointment of judges. The amendment also separates budget and administration of the Supreme Court from the Ministry of Justice, unlike local and county courts which remain subordinated to the Ministry.

The Hungarian judicial system suffers from a shortage of well-qualified judges, particularly in newly-emerging commercial areas. Judges are appointed for life by the Hungarian President and may be removed only for cause. (Ch. X, sec. 48) They do not enjoy particularly high status or pay, and over half work on a part-time basis. (Ostas 1992) Over the past few years their workload has more than doubled, due to the registration of new private companies, the rapid rise in the number of commercial disputes, the rash of new compensation claims, and growing criminal activity. In order to alleviate the judiciary of this increased work load, the Ministry of Justice sought unsuccessfully to reestablish the administrative courts—which had been abolished under the socialist regime—in order to adjudicate alleged violations of citizens' rights by the state.

An area needing particular attention is debt collection. Of the total number of 700,000 law suits filed nationwide last year (a 60 percent increase from the previous year), two-thirds of those cases involved uncollectable debts. Streamlining debt collection, perhaps by allowing private debt collection in uncontested cases or reducing procedural requirements in judicial cases, could relieve much of the current strain on the courts.

Arbitration could be a useful alternative to court procedures as a means to resolve commercial disputes among private parties. As in other CEE countries, the Hungarian Chamber of Commerce has an arbitration chamber that specialized during the socialist period in the settlement of international trade disputes. The 1988 Act on Business Organization gives this court jurisdiction for disputes arising out of a company's articles if the parties agree. A broader mandate and proper technical support could help this body develop into a viable alternative means for dispute resolution. A new draft arbitration law now under consideration would give access to the Chamber's arbitration to anyone doing business in Hungary.

[86] One area under active discussion involves overhaul of the court structure: whether a four level court system should be introduced or a modification of the current system is adequate, and whether the Ministry of Justice or the self-governing Judicial Councils should be the guarantor of the lawfulness of court procedures.

The legal profession

Law-Decree 4 of 1983 on the Legal Profession broke the close ranks of the "legal working groups" and allowed company attorneys to compete in dealing with economic organizations. Act XXIII of 1991 amended the 1983 law to give Hungarian attorneys the right to establish law offices (with two attorney minimums) or individual practices. Attorney working groups have to transform themselves to Law Offices. Admission to the Bar requires a law degree, professional exam, Hungarian citizenship, permanent domicile in Hungary, a clean record and liability insurance. Practicing attorneys may not take up other employment, except educational (teaching) or scientific/doing research. Currently there are about 1200 practicing lawyers in Budapest. Foreign lawyers can open representative offices and provide legal assistance on foreign legal matters, but may not practice Hungarian law.

Conclusion

Hungary has been on the forefront of CEE countries in reforming its legal framework to promote private sector development. It was among the first to make major changes in its Constitution and Civil Code to promote free enterprise and put private property on the same legal footing as state-owned property. It moved quickly to establish a Constitutional Court to protect these legal rights; its Court has extremely broad jurisdiction, and has proven very active in reviewing economic as well as social legislation. With regard to formerly nationalized property, it is the only CEE country to eschew widespread restitution in-kind, opting instead for a coupon scheme that is likely to cause significantly less uncertainty and disruption in property markets. It has basic legislation in place to protect intellectual property and to provide a clear and flexible framework for the setting up of domestic or foreign-owned firms. Finally new and relatively modern antimonopoly and bankruptcy laws went into effect at the beginning of 1991 and 1992, respectively.

Despite these achievements, however, numerous legal and institutional challenges remain. The most difficult area (apart from company privatization, which is not discussed here) remains real property. The development of efficient land markets continues to suffer from an inaccurate land registry, an underdeveloped legal and institutional framework for collateral, the near impossibility of eviction in cases of nonpayment of mortgage loans or rent, and an outdated and incomplete zoning and regulatory structure. Further substantive scrutiny is also called for in other areas of law, most notably in the areas of bankruptcy and competition.

Finally, the challenge of implementing all of this new legislation is daunting, particularly given the country's limited experience with market principles and institutions. Both the specialized institutions (such as those charged with implementing intellectual property and antimonopoly laws and with registering companies) and the regular courts are in danger of being overwhelmed with the burgeoning caseload. A prime example is bankruptcy, where over 14,000 new cases were filed in 1992 alone. Another is antimonopoly law, where the broad legislative mandate and the relative inexperience of the regulators could create the potential for counterproductive results. In addition to training and technical assistance, Hungary should work to provide widespread dissemination of the rulings of the Office of Competition and the courts more generally, both to educate the public and to promote public accountability and oversight.

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VARIATIONS ON THE THEME OF SELF-PRIVATIZATION

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This analysis is built on corporate case studies and presents the practice of decentralized, market-conforming privatization using examples of firms that have already been sold under the programme. The paper shows the main characteristics of the firms sold, analyzes the bargaining with consulting firms, the ownership structure, financial conditions and the consequences of the buy-out process. Some of the experiences can be generalized to all employee buy-outs, privatization leasing and capital-saving or free distribution of assets. Therefore this study can be regarded as a starting point for the evaluation of the likely effects of these privatization methods, suggested by the government.

The essence of self-privatization is that transformation and privatization of firms concerned occurs "without direct participation of the State Property Agency"[1]. A large proportion of proprietory (asset-managing and selling) rights of the SPA has been transferred to the consulting firm, the latter being recognized by the SPA—through tender—as reliable and knowledgeable. Firms singled out for sale have been able to choose freely their own consulting firm from those on the list.

The Financial Research Ltd. has started an empirical research on the practical functioning of the new method by carrying out case studies.[2] The analysis below summarizes the experience of firms sold up until the fall of 1992,[3] representing a small proportion of more than four hundred firms assigned to the self-privatization programme. Although up to the end of 1992 85 percent of them had a contract with a consulting firm (i.e. they had started transformation) and 53 percent had been transformed into company form, the privatization process had been completed with only 20 percent of them. At the time of the investigation in mid-1992 there were only 20 firms eligible for our research.

The six cases do not represent, in a statistical sense, the whole sphere of self-privatization. Nevertheless, they do show the characteristic types of firms privatized in the early stages of the process, and thus also the pitfalls and tricks used. Four of the firms investigated became the property of domestic investors and two were sold

[1] Enabling contract between the State Property Agency and consulting firms, September 1991.

[2] The present article is based on a summary study of empirical experiences. It will appear soon in the series "Jelentések az alagútból" (Reports from the tunnel).

[3] The case studies summarized here were written by Péter *Karli*, Kálmán *Kőhegyi*, Ferenc *Lévai*, Sándor *Molnár*, László *Neumann* and Éva *Voszka*. We are thankful to officials of the State Property Agency, specialists of Pri-man Ltd. and managers and employees of the firms and consultants concerned.

to foreigners. This is in line with the shares of ownership calculated according to the income of the SPA.[4] Four of the six firms are engaged in industry and construction, two in services. That means that the latter have a smaller share in the sample than in the original set.

One of the firms selected was included into the privatization list by mistake, although it had not taken part in self-privatization: its sale was carried out before the start of the programme. This firm, referred to as the "first swallow", was also included into our sample in order to compare the different privatization procedures. With self-privatization the "doubled" firm accomplished a transformation process that had been started earlier. The label "successful privatization—bankrupt firms" was given to two firms bought by foreigners. The case referred to as "forced privatization" deals with a firm which the employees did not want to buy. Finally, "simple" employee buy-out is a reference case for comparison.

Preconditions: autonomy and relative stability

Looking at the starting position of sample firms that were sold first it is striking that—with the exception of the "doubled" firm—all parted from a larger firm in the eighties or in 1990–91 when units within large firms could relatively easily initiate their organizational autonomy. This is understandable considering the over-representation of industry in our sample; without splitting up such firms could not enter the club of the 300.[5]

It is partly due to their large firm origin that privatized firms were characterized by relatively stable financial and market positions. Those units that were most eager to separate were ones which could confidently assume that autonomy would be favourable for them. Ministries that made decisions in cases of organisational change ensured that only "feasible" firms (i.e. firms not threatened by bankruptcy) could obtain a licence.

It is not certain that the logical chain: "gaining independence—good economic results—rapid privatization" is also the causation. Perhaps there is one common cause behind all these phenomena: namely, a strong, entrepreneurial management which is able to produce both acceptable economic results, and organisational and proprietory changes. When evaluating results we should mention that the most important performance indicators (sales, profit and number of employed)

[4] At the end of 1992, the income of the SPA from self-privatization was more than HUF 3 billion, one third of this hard currency. According to the data of Pri-man Ltd. the other two thirds were distributed equally between "employee" and "other domestic" buy-outs. However, our case studies show that the borderline between the latter two categories is blurred.

[5] In the first phase of self-privatization the SPA included firms with assets and yearly turnover (according to 1990 balance data) less than HUF 300 million, and with less than 300 employees.

have in the past one or two years deteriorated with almost all the firms in the sample.

Autonomy that has been gained in the recent past explains not only a relatively good financial-market position but also stronger activity. Autonomy gained in fierce battle had to be preceded by reconsideration of perspectives, close cooperation between managers and employees. The latter required a mature relationship between the two sides.[6]

The seed of self-privatization fell on fertile land in the cases of five firms. More precisely, the "first swallow" started privatization itself in the summer of 1990, long before the start of the programme. It was already clear at that time that employees of the firm would like to buy the firm, and after a short period of wrangling with the SPA their conception prevailed.

An argument put forward by the initiating firm's management referred to the deteriorating market environment and the need to strengthen the proprietory attitude of workers. The data of the firm, however, did not show that the firm itself was in recession. The real motives might be found with two emphasized factors. On the one hand, in August of 1990 the managers of the firm feared that their best employees would depart in order to start their own business. This would have weakened the remaining part of the firm and at the same time it would have created competitors. The management opted for an "offensive" escape: it initiated an employee buy-out as an alternative to increasing the number of market actors, strengthening competition, and bringing about a kind of decentralisation.

The "first swallow" was also threatened by another type of decentralisation. This was because—beyond its service plant—it also possessed a retail outlet, that was regarded as an important source of income. Primarily, it provided the cash which was so important for overcoming daily financial problems. Administrative interference could be avoided by shunning the small privatization programme. These motives reveal that the plan for changing the proprietor was meant to mitigate competition, to maintain the market, and to preserve the integrity of the enterprise.

The avoidance of decentralisation was also a strong motive behind "simple" employee buy-out. Two outlets of the retail network had fallen victim to small privatization at an earlier date. To keep the firm together was in the interests not

[6] In most cases investigated for this study this was the case but there were exceptions too. With the "first swallow" and the "simple" employee buy-out, splitting away occurred several years before privatization; with the "forcefully privatized" firm nobody wanted to split away. In these cases there is no direct connection between organizational and property changes. Internal coalition is not always durable. In one of the "bankrupt firms", after splitting up the workers and unions reinstalled the CEO (chief executive officer) who had been sacked by the large-firm headquarter. This was because of his efforts to maintain autonomy. Having returned to his previous position he soon found himself face to face with collegues who were for an employee buy-out, whereas he was for foreign investors.

only of high level managers and the corporate headquarter but also employees with special skills. Splitting up would have threatened the firm with a change of profile. Therefore in 1990 the chief executive officer (CEO) raised the idea of an employee buy-out. The plan was not very popular and thus they tried to find a foreign partner with unparalleled success in their trade. According to the preliminary privatization agreement initiated by the investor, the foreign partner would obtain the majority share and the employees the minority share. However, at first the SPA "let the case drag on", and then directed the firm into the self-privatization programme. The long wrangling and the unsuccessful bargaining with local councils over the rental thwarted the plan, and for want of a better option they turned again towards employee buy-out.

"Successfull privatization—bankrupt firms" also started preparations one year before the announcement of the self-privatization programme. The motive here was undeniably the deterioration of the market situation and the interest shown by several foreign buyers. The two firms had the same profile and originated from the same large enterprise. Their markets have been shrinking for years but they hoped that the World Exhibition would reverse trends. Besides this, the activity pursued by the two firms is restricted in developed countries by strong environmental constraints, which had not at that point been applied in Hungary. The foreign buyer offered the firms concerned the chance to widen markets, to diversificate the production structure, and to modernise the technology.

The "doubled" firm now has large markets and is still profitable as a result of the reconstruction and change of product structure five years ago. The first steps towards transformation started in the period of spontaneous privatization. In early 1990 managers considered the involvement of foreign capital as opposed to an employee buy-out. They preferred the latter but at that time financial conditions for a buy-out were much more uncertain. Therefore the majority of the employees, with a few million HUF of initial capital, set up a limited liability company. This rented or leased buildings and equipment from the state firm and pursued its activity under unchanged conditions. The state firm preserved only the function of "asset management".

The motive for creating the new ltd. was officially to strengthen the proprietory attitude of the workers and speeding up privatization. In this case acceleration meant the discouragement of potential outside investors. The contract concluded between the state enterprises and the company for an unspecified term, was very advantageous for the latter. Thus any serious interest of outside actors to buy the enterprise was excluded.

Finally, in the "forced privatization" case, participation in self-privatization had no antecedent. The firm did not strive for new solutions and was not in the vanguard of those firms that wanted to manipulate regulations and the law. It was not fond of the splitting-up of the large firm and the gaining total independence. Even now, the company stresses the advantages of large size and criticises the fashion of splitting up. It also has similar opinions about the latest "vogue". The CEO said in the fall of 1992, after the employee buy-out: "I cannot understand what private property for this size of firms means. I do not see a difference in my boss being the minister, a large firm or the general assembly. To tell the truth, I do not understand what the merits of privatization really are and I am not convinced of its advantages." He evaluated his situation and possibilities with irony: "I learned from a daily newspaper that we are included in the programme. If I am told to privatize I have to do it. This firm never made scenes. I am the manager of a state enterprise and have no say in the matters of sale and the changing of the proprietor. If self-privatization had not been started nothing would have happened at the firm."

This quotation refers to the fact that the firm was automatically included in the programme as were all the firms of the sample.[7] The inclusion was welcomed (with the exception of the "forced privatization" case) as a possibility for privatization within a framework regulated and approved by the government.

Bargaining around self-privatization

The "first swallow" not only failed to take part in self-privatization but had no consulting firm either, although it could have chosen one outside the programme. The whole transformation and privatization process was planned and executed by the CEO himself (as it was characteristic of many other strong firms and strong managers). It required one year of hard work. "I bothered the SPA for months, made the long journey to Budapest and back one or two times weekly. Reconciliation was tedious."

Under self-privatization, this tedious task was carried out by the consulting firms. Enterprises concerned unanimously assert that once they have entered the process of self-privatization they had nothing to do with either the State Property Agency or the Pri-man Ltd., its subsidiary having been set up for controlling the program. The CEO of the "forcefully privatized" firm did not even know about Pri-man. (A lucky fellow, might say the CEO of the "first swallow"). However, it was mentioned that in the case of every firm the consultant steadily reconciled the next step of the process with them.

The first level of bargaining was between the consulting firm and the firm to be privatized, before the consultant was chosen. There was a rich supply of consultants and they often had to compete in formal tenders.[8] Only consultants

[7] Other firms, primarily service units who feared small privatization and splits, often tried to join self-privatization voluntarily.

[8] According to the rules of self-privatization the costs of transformation into a company are paid by the firm; the Property Agency pays only for privatization.

meeting the requests of the enterprise management were negotiated with. Requests included the acceptance of the new proprietory structure, which was particularly important in the case of an employee buy-out. When "bankrupt firms" were sold to foreigners the basic criterion was new investment, technology development and limited laying-off of employees. In the case of the "forcefully privatized" firm the sphere of activity, the markets and employment were to be retained and foreigners were to be excluded. The managers argued that although the firm was small it was at the junction of a large production chain, i.e. it had monopoly position. Sale to foreigners would weaken other members of the chain and possibly cause a break-down of production.

The second level of bargaining concerned important questions of transformation and privatization. The two steps were considered by every firm as being attached to one another, i.e. the framework of the company was established according to the plan of changing the proprietor. In the cases of employee buy-out, the managers and employees of the enterprises acted (in their relation to the consultant) not only as customers but also as buyers. In such cases the consultant was not only the agent of the buyer but also a seller whose decisions were determined in final instance by the "real proprietor", i.e. the Property Agency.

Between the buyer and seller thus conceived the main issue was asset evaluation. The "first swallow's" management as the potential buyer wanted to rely on asset evaluation based on returns, whereas the Property Agency preferred the capital value that figured on the balance sheet. It is a general phenomenon, independent of the self-privatization method, that buyers—be they outsiders or insiders—find asset evaluation based on prospective return realistic. This is understandable not only because they try to minimize investment, but also because credit repayment and income to be earned from the firm all depend on profit. However, the Property Agency sticks to the fixed point of asset balance because it wants to avoid being accused of "selling at a loss". Consulting firms tried to overcome the problem by adopting special techniques that would not harm the interests of the Property Agency.

One possibility was known as the "revolving income". In 1991–92 it was possible to return up to 20 percent of the income from the sale to the newly formed company.[9] The problem was, and this appeared in the case of "first swallow" too, that to buy the ploughed-back part no preferential credit was given. However, compensation could be obtained in several forms.

In the cases of "successful privatization—bankrupt firms" the consultant found a solution satisfactory for all sides. The foreign buyer made no claim for a return and in exchange obtained a 20 percent price rebate. The consultant ar-

[9] This possibility was ruled out by the privatization laws adopted in the Summer of 1992. The Board of the SPA adopted a resolution whereby, with transformations started under the old regulations, a refund would be possible.

gued that it would be irrational to force the new proprietor to raise capital ex-post, and preferential employee share ownership could be stimulated by other means, e.g. by credit provided by the buyer. As a result of the price rebate the consultant seemingly lost a part of his fee. Yet since in any event he would not have obtained commission after the revolved-back portion, his position did not deteriorate either. On the contrary, he could close the deal rapidly and obtain a high-speed bonus.[10] The other parties did not come off badly either. The foreign buyer bought the firm cheaply—or, more exactly, he bought a smaller share of assets. The revolved 20 percent would have been paid in foreign currency and during the long period of refunding it would not pay interest and would have also been subject to an exchange rate risk. In the final assessment the Property Agency (and the Budget) did not lose much either; in fact, it lost only the interest falling on the period between payment and refunding.

The other type of compensation was worked out by the Property Agency. The "first swallow" obtained permission to set aside ten percent of the value of assets beyond its initial capital. This reduced the need for credit and was in part a security for repayment—without any formal reduction of those assets.

The assets over the initial capital (the so-called reserve capital) had an important role in the transformation of the "forcefully privatized" firm. Its consultant applied "two-tier privatization" whereby large areas of activity and a large part of fixed assets were separated and set aside as reserve. Since the intention here was an employee buy-out, the reduction of the capital was not against the interests of employees acting as buyers, because they were convinced that losses would not be large.[11] The Property Agency accepted the plan since assets designated as reserve capital (workers' holiday home, transportation equipment and machines) were to

[10] The consultant fee paid by the Property Agency for privatization is determined as a percentage of the sale price. The base does not include a rise of initial capital, subsidized employee shares and revolved capital. Rapid closing is awarded with a bonus. The privatization of "bankrupt firms" was terminated in December 1991, a few months after the announcement of self-privatization. Thus the consultant obtained, beyond the 5 percent base fee, the maximum 7,5 percent bonus. Speeding up was in the interests of both the workers and the outside investor, who could apply at the last minute for tax allowances that were abolished in 1992.

[11] Losses were caused first of all by the abandoning of one part of the firm's profile, (raw material production) due to the splitting away of certain areas. The firm has since then had to rely on outside suppliers. This has not caused surplus costs according to the firm's managers; in fact, larger capacities and competition between suppliers may reduce costs relative to self-sufficiency based on obsolete technologies. A second aspect to note is that the headquarters and a large store were situated on the lost territories. The value of the office building was to be refunded by the local government and the price was regarded as realistic even by the managers. However, the money is not enough to build a new office. With regard to the other piece of real estate they say that they will not need such a large store in the future. "When reviewing inventories we found a large amount of superfluous items", said the CEO, "and procurement is much easier now than it was a few years ago. I can buy anything within hours, I do not wait for weeks or months. Therefore, a large store of this type is not necessary and we will not build one."

be sold and the income was to go to the SPA. This method did not increase the number of market participants but it did increase the volume of assets privatized.

"Two-tier privatization" sometimes helps the change of the proprietor and is well-adapted to the now popular practice of selling firms after splitting up. Some variants of this form were used frequently in 1992. The division of income from set aside assets was determined by bargaining between the Property Agency and the firm. Partial or total exemption from payment might be a new form of subsidy and the tool that saves a firm.

In certain respects the case of the "doubled" firm also represents a form of organisational decentralisation since two firms were set up to replace one. Here, unlike in the case of "forced privatization", the number of market actors formally increased. The volume of privatized assets grew not due to the split itself, but the subsequent steps: leasing and the buying out of the firm. (Another important difference is that organisational change was decided not by an outside institution but by internal forces). Adhering to the already existing organisation the state firm and the limited liability company formed separate joint stock companies. In the case of the latter, its initial capital has risen from a previous total of HUF 5 million to HUF seventy million: as a consequence of the leasing contract, machines became the property of the partnership. The 180 employee shareowners thus acquired 14 times the original value.[12] When a tender was announced for the rest of the state firm, burdened with a disadvantageous leasing contract, interest was scant. The only serious offer was made by a 34 investor group. Not surpisingly most of the group-members were the employees of the limited liability company.

Determining the owners

One smaller group of proprietors acquired its new position by the force of law. Local governments get shares in the new firm according to the value of the land where it is situated. Whoever is in the position of the potential majority owner it is not in his interest to be open-handed when determining this value. The property share given to the local authorities reduces the base of the consultant's fee, too. The bargaining position of the local governments is generally weak—and not only during self-privatization.[13]

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[12] Thereby it is proved that a leasing agreement between the state firms and the limited liability company was favourable for the latter—in line with intra-firm power relations. When, during self-privatization, a small group acquired the majority of the firm's property the previous agreement was modified.

[13] It is debated in general, whether the value should be determined with infrastructure included and whether the commensurate part of credits taken by the enterprise should be repaid by the local government. (Local governments say it was not they who took the credit but the firm, so it is the firm that should make the repayment.) If local governments cannot defend their own interests during the period of reconciliation, the court has little chance of doing it ex post.

The second obligatory decision concerns the quantity of preferential employee shares. In the employee buy-outs investigated this preference was given for up to 15 percent of the property, in the two cases of foreign investment for up to 10 percent. According to the author of the case study, the lower share was not requested by the buyer but was a result of the gross wage and the per capita yearly wage constraint.

This was the more likely case, since the foreign investor supported the ownership of employees. As we have already mentioned, he financed even the necessary downpayment. At the same time he had the option of buying back the shares after a few months at market price but in any case not lower than the face value. In fact this happened three months after privatization. Employees sold their security, having obtained the whole state subsidy in cash. In other words, they transformed their property share into some sort of "privatization bonus". The buyer, who was now in full possession of his rights, put pressure on the employees to sell their shares. The chief accountant of a firm was called several times by telephone on the day before the deadline to find out whether he saw the matter in a favourable light. Despite this, some individuals refused to do so. At one firm such a person was the former president of the enterprise council. He was the first among those fired.

This story reveals that the breakdown of property is influenced by intra-firm power-positions and bargaining. This was even more characteristic in cases of employee buy-out.

The example of the "first swallow" is particularly interesting since this was a case which set a precedent for the Property Agency. In order to handle its special conditions, the management introduced a rather sophisticated technique. SPA requested that every employee be given the possibility to acquire property and also to choose his partners-proprietors. The group of owners was determined in two rounds: first application and then secret ballot.[14] When the down payment necessary for credit had to be made, 13 of the 43 proprietors withdrew. The others decided not to offer these shares to new members but bought them themselves. Finally, 18 large and 11 small shareholders out of the fifty employees became the proprietors of the firm. The former now own 73 percent of the shares. The determination of the range of proprietors was not so formal in other cases. It was essentially built on voluntary application but was influenced beyond financial strength by the "fine structure" of intra-firm relations.

[14] The principles, accepted by the general assembly, limited the range of proprietors to 35 percent of the workers. This limitation was based on foreign experiences. Similarily, with reference to foreign experiences, they differenciated the group of large and the small investors. The ratio between the two types of share was laid down as one to four. After accepting the principles every employee had to declare whether he or she wanted to be a proprietor, and if so whether with a small or a large share. If there were too many applicants in either group, those concerned decided in a secret ballot who they wanted to be their fellow-shareholders. Thus from the 33 large shareholder candidates 22 were chosen, while from the 30 small shareholder candidates 20 remained.

However, it seems to be a general phenomenon that managers of different ranks have had a decisive position in all the "employee" buy-outs investigated.[15] Employee buy-out is essentially always management buy-out and therefore it would be more to the point to call it by this latter name. One of the motivations of managers is that they have to be diligent subscribers in order to show their confidence in the firm. Yet perhaps it is more important to note that only they can judge the likely risks and possibilities, and they see their decision-making positions and managerial posts to be more secure if they are proprietors. In cases involving a "simple" buy-out and the "doubled" firm—as we have seen when analysing the antecedents of privatization—the fending off outside investors has also had a role.

Our investigations reinforced the assumption concerning the fact that the workers are not motivated by the goal of becoming proprietors, but by the aim of keeping the workplace and the number of jobs in existence. This is true despite the fact that management declared before starting the deal: "to buy shares is no guarantee against being laid-off".[16]

The distribution of shares was most equal with the "first swallow". We have seen, however, that the range of investors was narrowed down here too, when the shares of those who withdrew were taken over by the rest of the group. The management believes that the firm is hard to manage even under the present conditions. The CEO now thinks it would have been better to limit ownership to 3–4 people who would own a 51 percent share between themselves. This he substantiates by the experiences of just one year of existence: "the majority of the members of the partnership do not show a proprietory attitude... The "wage labourer" attitude is characteristic of most of them. Long-term investment is not appreciated because of imminent problems of how to make both ends meet. They cannot throw off the party-state attitude towards common property. There are positive developments in daily work and in keeping the plant and the shop clean... Assemblies are quiet, contribution is minimal and that contribution is confined to unimportant problems."

Similar phenomena and evaluations are also mentioned by another firm whose experiences with the company form are over a longer duration. When privatizing the state-owned portion of the "doubled" firm the range of proprietors was con-

[15] In the "simple" case, among the 20 proprietors 16 are managers and the CEO himself has a share of over one quarter. In this case the new proprietors before the deal have created a separate partnership to take the E-credit. In the "forced privatization" case, interestingly enough, not one but two companies were created to buy out the firm. In the company of the managers five of them hold 62 percent of the shares. The buyer of the state portion of the "doubled" firm is represented by a 34-strong group. It includes the CEO, 31 people from among the proprietors of the company and two outsiders (acquaintances, old customers). One of them has an almost 20 percent share, while the CEO of the company has a one-third share.

[16] The only relevant case in this respect is that of the "first swallow", whose buy-out occurred more than one year earlier, in 1991. Employment at the firm decreased even in 1992, after privatization. However, no proprietor was fired.

siderably narrower than with the previous leasing-based employee limited liability company. Managers did not hide the fact that they wanted to limit the size of the investor group. They referred to the fact that in the previous partnership too, control was cumbersome and—due to small shares—the "proprietory consciousness" was under-developed. Since managers obtained enough cash from outside investors they did not want to break disposition rights and assets into little bits.

The financial preconditions of employee ownership

In all the cases investigated in this study the source of buy-out was the E-loan, a preferential credit. Personal investment and a guarantee based on private wealth was always minimal. The personal contributions of proprietors was a few thousand forints, and only in the narrow group of "large capitalist" managers investments amounted to HUF hundred thousand.[17]

The immediate consequence of this situation is that bank contacts are the key problem of privatization. Credit was generally obtained by the consultant through his personal contacts. As one of the case studies put it, this was an "inestimable help" to the firms. The second consequence is that partnerships have been highly indebted right from the start and have been helpless against the creditor financial institution. Finally, due to the high share of credits the majority of owner-employees have not taken a high personal risk.

According to the CEO of the "first swallow", they not only had long periods of bargaining with the Property Agency but "negotiations with the bank were also tedious. To judge a credit application took 110 days. True, this was the first case of an employee buy-out and also of awarding an E-credit, so there was much hesitation despite the good faith of the bank." A personal contribution of two percent was enough, but credit was given at that time to private individuals only.

Since the beginning of 1992 partnerships have also been able to obtain E-credit and this has further decreased the personal risk involved. On receiving word in December of 1991, that there would be a change the would-be proprietors of "simple" buy-out founded an "asset managing" limited liability company. The initial capital available was equal to the share of the company, which was to be bought by employees at a discount price. This "asset manager" took the credit necessary for buying the state property in two instalments, so that cash requirement would be minimal. As collateral they offered their most valuable real estate and the bank stipulated prompt collection from the account of the limited liability company.

[17]This suggests that the size of the property acquired was determined not only by financial strength but by rank and the desire to have influence. Even the largest sums could have been produced through a family loan or the sale of a car or hobby-garden if somebody was keen to do this.

At the "forcefully privatized" firm partnerships were also formed to manage the buy-out that took the E-credit. Here they did not employ the trick of splitting the amount: they paid 25 percent in cash. In the opinion of the management the conditions of the bank were very strict. The bank took the whole firm as collateral and demanded a cash payment guarantee and prompt collection of increments. Beyond that the bank retained the option of buying the firm for the price at which the employees bought it. The firm cautiously raised the idea that the creditor could have an interest in driving the partnership into bankrupcty. In their opinion "banks deal with such actions not for the interest rate. If only half of such contracts fail they obtain huge sums."

Can the new partnerships pay their debt? Managers are more or less optimistic about this, but the result is far from certain. The "forcefully privatized" firm stressed that with a 25 percent downpayment and 15 percent subsidized employee shares their ownership would be already large enough. They will do their best to pay back the debt rapidly. If the debt and the leverage the creditor has over the firm thus shrinks they think they can strike a bargain with the creditor over rescheduling.

The managers of this firm think that to buy 75 percent of some asset for credit is very risky. In their opinion such a huge loan results in the forced drawing away of the firm's income. This can only be afforded by very strong firms, for otherwise collapse would be unavoidable. "If anybody were to ask me about the meaning of buy-out," said the CEO, "I cannot say anything other than that this is not a good investment. But we had no other way out. It is unfavourable for the firm that the change of the proprietor is expensive. No fresh capital is drawn into the firm and the most urgent investments also have to be delayed for years. Adhering to our old principle, we try to pay back credits as soon as possible in order not to depend on anybody."

The firm which went through the process of a "simple" buy-out wants to pay ahead of schedule if current income makes it possible. If however it cannot pay according to schedule it might try to raise capital by luring a foreign investor or by selling the rental of its premises. The latter step would involve the assent of the creditor. Moreover, rental would threaten the profile of the firm and with it the job security of employees (among them many share owners).

All these options mentioned above are at best ideas, at worst wishful thinking. Repayment of E-credit begins after a one-year period of grace. For the majority of firms sold under self-privatization—for three among the six investigated by this study—problems should become acute only by the second half of 1993. The "first swallow" is already meeting obstacles. It is not in danger as yet, but the firm—similarly to the "forcefully privatized" firm—right from the start thought it would be risky to take credit, and wants to speed up repayment by selling real estate in order to be less dependent on the bank.

According to the detailed calculations of the CEO of the limited liability company, return on capital necessary for repayment was 50–56 percent in 1991 (depending on the construction used). A return of this magnitude can only be expected from selling drug or from a brothel but not from an ordinary venture, as the popular saying goes. As the analysis of the "first swallow" has demonstrated, in 1992, despite the easing of the conditions of E-credit, the situation deteriorated further[18] (the required rate of return on capital has risen to 51–60 percent). The CEO stated that "the government is for privatization only in words, and in reality it hinders it through the severe conditions of taxation. The present system of taxation will result in the failure of the program." He added that, knowing the regulation for the year 1992, he would not start the buy-out in the same way. He would not buy the whole firm, only its "core" and organize the remaining parts into small companies.[19]

The above analysis shows that for such ventures the main problem is the centralisation of income by the budget and not the high rate of interest. Therefore, the change of the conditions of the E-credit in 1993 is not very useful for investors. Credit conditions and taxation constitute a complex system and thus changing one element of this system misses the point. In addition, the high level of income centralization influences demand. If the market shrinks—due to high taxes or an increase in VAT—then the recession will drag on. Despite cheap credit or the state's distribution of free assets, many ventures will not avoid bankrupcty.

After privatization

We have one more question to answer: what happened to firms after privatization?

We have cited the two firms bought by foreign investors as cases of "successful privatization—bankrupt firms". This is because privatization that started in simple and auspicious circumstances has turned suddenly into a failure from the point of

[18] The interest on the subsidized loan and the source tax on the dividend have been lowered. However, these positive effects were neutralized by the termination of the investment allowance: the tax base cannot be reduced by credit repayment. On the other hand the interest assumed by the company in place of individuals is a cost factor which is not directly related to the operation of the firm. Therefore it adds to the tax base of the partnership.

[19] The CEO of the "first swallow" formulated suggestions concerning the whole regulation. Among them we find a six-year profit tax allowance for (majority) private property partnerships; interest on E-credit taken over by the partnership should be accepted as a cost factor; and investment allowance should be granted with respect to the repayment of loans. He would deem it necessary—in a case in which the partnership repays E-credit from the sale of assets—that the difference between accounting value and sales price should not be included into the base of the profit tax.

view of the firm. In both cases the new proprietor has reduced the workforce radically[20] and in a very crual way. After the first dismissals, which involved approximately half of the workforce, work contracts for an unlimited term were replaced by three-month contracts. Those who did not want to sign the latter (with one firm this included the previous chairman of the firm council) were fired at once. They obtained severance pay, but the company had no obligation to pay those who were fired after their contract had expired.

The question arises, how the consultant or the state has represented the interests of employees. According to the author of one case study, the demands of workers have been much more difficult to enforce under self-privatization than under other type of sales. However, the firms—or more precisely those who still work at the firm—have not blamed the consultant: it has promptly and accurately informed the employees about the development of transformation and privatization, the arrangements for subsidized shares, and he has obtained credit and a lump sum privatization bonus from the new proprietor. Initially the former managers also retained their positions. Short-term interest assertion was successful, but long-term assertion was not (the latter would have meant the preservation of jobs).

The buyer had verbally promised that there would be no large-scale dismissals. According to the consultant it would have been no use putting guarantees in writing since it would have probably thwarted the whole undertaking[21]—which would have been unfavourable to both the consultant and the firm. Also, it would be difficult to include garanties. The new proprietor would always be able to refer to changes in market conditions or the conditions of regulations and thus fend off responsibility.

In cases of employee buy-outs the situation has been better—at least up until now. With the "first swallow" there have been dismissals but on a far smaller scale than with "bankrupt" firms. They have had good chances to maintain their market positions. Their futures, based on a service contract with a foreign firm, seem to be bright. Management of the "forcefully privatized" firm—that is, the new proprietors—said they did not have to dismiss anybody. It is true, that many employees had to be transferred to new jobs, and they have had to master new tasks. Those who are able and ready to adapt, will not be fired. The partnership

[20] From the original ninety (later only seventy) employees ten have been retained. At one partnership the previous CEO, who retained his post after transformation, was among those sacked. The CEO of the other firm gave in his notice since he was stripped of all his authority and his income was substantially reduced. At the same time, the buyer at one partnership started large investment. However, this resulted—despite promises to the contrary—in changes of technology and dismissals. The foreign owner claimed that the present level of employment—one tenth of the previous level—is the normal one at Western firms in this industry.

[21] The buyer in this—not exceptional—case was in a monopoly position, and he knew about this from long negotiations started before the self-privatization programme began. He sent the only valid offer to the open tender.

which underwent a "simple" buy-out plans to increase employment. This is despite the fact that its turnover, instead of increasing in 1992 by 16 percent as planned, decreased by an even greater percentage. Internal organisation and the incentive system have already been transformed and they have put their faith in the demand-boosting effect of reduced inflation.

The examples given here point to the fact that a foreigner is less sensitive to worker interests than the employees themselves, if they are the new proprietors. This is natural, because the main goal of a worker buy-out is to maintain employment—although this is not always the most efficient solution. On the other hand, it has to be taken into account that this type of privatization—at least in cases analysed here—is characteristic of the more stable firms, i.e. those in a good market and financial position. In other cases problems might be larger and we should not forget that in the firms considered in this sample the new proprietory structure had been created only a few months before. Although good faith can be assumed everywhere, it is not certain that the future will be shaped by favourable conceptions. In a repeated investingation a few years later, we would find slimmed partnerships or empty shops, or ventures destroyed by competition.

There are other arguments too for not assuming a too close and one-way relationship between unemployment and privatization. Employment reduction has not been so spectacular with other sales to foreigners as it has been in the case of "bankrupt" firms—and this includes firms within the programme and outside it. Other studies that have investigated self-privatization prove that dismissals are timed just before transformation or a change of proprietor, and in this way they serve the survival of the firm. Thus we can draw the conclusion that the fate of the firm is largely influenced by the proprietory structure, but it is not the only determining factor. Privatization is not a panacea in itself. Equally important are market competition, demand, taxation and the general business environment.

What is (self) privatization good for?

First, the inclusion of a firm in the programme of self-privatization, or its transformation into a partnership, is not a guarantee for privatization and is not enough to avoid bankruptcy or liquidation—with or without a change of proprietor. It is now clear that many illusions have been attached to this method of privatization, as has been the case with other privatization techniques too. "He who thought that four hundred firms can be sold in a year engaged in wild-goose chase", said many of the participants.

The mood of "expecting a miracle" had a double source, as is so often the case. The partisans of the method have a natural inclination to overestimate likely success in order to gain acceptance. It is evident that tactical arguments tend to produce exaggeration. "Dishonest praise" makes attack easier for the other party too, since exaggerated objectives cannot be fulfilled: thus there is a large gap between promises and reality.

The second point is that the programme—unlike direct renationalisation and small privatization—has been unable to reverse the previous processes of "spontaneous privatization". Self-privatization has been built on former corporate strategies and their implementation. The programme was not started in a vacuum, and the antecedents have contributed considerably to the success achieved so far. However, the other side of the coin is that—as the author of the study on the "doubled" firm has written—"one cannot rule out much debated spontaneous privatization when management "negotiates with itself", in the role of both buyer and seller, about the conditions of sale. At the same time it maybe the case that these were the firms which elicited attack against the self-privatization programme".

The third point is that, from the point of view of privatization, the actual financial position of the firm (debt, liquidity) is less important than the market and in particular its perspective. The case studies demonstrate that the process of privatization has been smoothest (both in financial and market respects) with ventures that have been relatively stable. These deals have ended in most cases in an employee buy-out. If the present market position has been weak, but the profile appears to have a bright future, outside investors (primarily foreigners) have appeared on the scene. In such cases more capital and more risk-taking are needed in order to weather the transitory period before the larger profits materialize.

If the buyer is an outsider or a foreign investor it is difficult to make stipulations concerning future investment or employment. It seems to be rather useless to try to do so, since would-be proprietors either do not assume any such responsibility, or if they do they cannot be made accountable. Special stipulations—like the old model of responsibility for provision—might be a cause for requesting special favours.

The fourth aspect to note is that the majority of so-called "employee buy-out" can be regarded as management buy-outs. Even if the proprietory stratum is wider, what counts is the plans of management both with regard to the details of privatization and to further operation. The main goal of workers has not been to become owners but to preserve their employee status. "The proprietory attitude" has remained weak even after privatization. Many small proprietors can be as easily manipulated by "large capitalists" most of them managers, similarily to the former enterprise councils and general assemblies. After buy-out, even if the original proprietory structure has been balanced, the concentration of shares can rise rapidly.

A fifth observation is that employee buy-outs have involved large credits. The change of proprietor has not only failed to draw in additional capital, but it has also created a situation in which, for a long period, income is syphoned away. Consequently, the chances for development, change of technology and markets have become less favourable than they were previously. This form of privatisation has compelled the taking of credit even by those firms whose original philosophy was against it.[22] The main problem with paying back credits has not been the high interest rates (thus the reduction of the rate of interest is not a solution in itself) but the general conditions of income generation and its redistribution: taxes, contributions and demand.

The ratio of loans to securities has been high in the case of employee buy-outs, because the participants only have small amounts of cash. They have held back investment even when they have had money: nobody likes to take a risk with his personal wealth. Minimalization of personal contributions has reduced personal risk. If a firm goes bankrupt after privatization (due to repayment of loans or due to lack of accumulation) employees would only lose a few thousand forints of investment (more significant would be the loss of their jobs). A venture with a high level of indebtedness and a weak sense of proprietory responsibility will be the result when the lack of confidence can easily become a self-fulfilling prophecy. Risk-avoiding behaviour does not diminish risk; in fact, it increases the threat of bankruptcy.

Under such circumstances, employee buy-outs may contribute to the liquidation of the firm, instead of preventing it. It may thus end up with a decrease ("consumption") of total assets and a reversal of the privatization process by transferring the assets to the state or to the creditor state banks. Thus the sale of a firm has not necessarily brought about a successful, final and irreversable privatization.[23]

All these refer not only to self-privatization but to any kind of employee buy-out. This is true for any kind of loan taken without personal contributions, and also in cases of privatization leasing. Our statement about proprietory behaviour and risk-avoidance is also valid for the free distribution of assets. Therefore the first experiences of the self-privatization programme raise doubts about the feasibility of using such methods in order to achieve the economic and social goals proclaimed by the government.

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[22] Here we have to mention that—paradoxically—traditionally conservative behaviour from the point of view of indebtedness is an indispensable precondition of employee buy-out. If the firm had taken large credits previously, as a state firm or as a partnership of the Property Agency, it could not add new credits in order to finance the change of proprietor.

[23] In the more favourable variant of continuous-multiple change of proprietor, employee buy-out is the first step followed by searching for an outside investor. This possibility—even if not realised—has been mentioned in our case studies.

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THE COMPETITIVENESS OF HUNGARIAN INDUSTRY*

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Using an RAS update to 1990 of an 86-sector input-output table for Hungary in 1986, and corresponding data on world-to-domestic price ratios for 1990, this paper calculates domestic resource costs (DRCs) for Hungarian industries. The disaggregated results are compared with corresponding estimates for a more aggregated model, using a 21-sector input-output table. The paper discusses limitations of the data, but finds that the main results are quite robust, since very similar rankings of sectors are obtained under a variety of conditions. Hungary's trade relationships and constraints on trade make it uncertain whether particular sectors, like agriculture, should be treated as tradeable or non-traded. Results are therefore estimated for both possibilities. Finally, the paper analyses the likely impact of the recently concluded Association Agreement between Hungary and the EC on Hungary's competitiveness, finding that some sectors will be strengthened, e.g. forestry, agriculture and food processing; and others will face more difficult conditions, e.g. extraction. Other sectors are not greatly affected.

1. Introduction

Although Hungary started to introduce market-oriented reforms long before they were taken seriously elsewhere in Central and Eastern Europe, the country's economy was still extremely distorted even in the late 1980s. These distortions took several forms, and frequently resulted from the bargaining over economic regulators between the central authorities and enterprises, which replaced the former central planning system. Thus distortions could take the form of favourable domestic prices for a given product or product group, various taxes and subsidies on production and/or trade flows, variations in the effective rates of profits taxation, or favourable credit terms (lowering the effective cost of capital).

From a strictly economic standpoint, the principal consequence of these distortions was to make the value added (or profitability) measured in domestic prices, associated with different enterprises, branches or sectors of production, an extremely unreliable indicator of their real economic worth to the country. From the financial indicators in domestic prices it was almost impossible to deduce whether

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a given branch, say, was really profitable for the national economy or not. This meant that even if they wanted to, it would have been immensely difficult for the authorities under Hungary's pre-1990 system of economic management to allocate their available investment funds according to the relative profitability of investment in different spheres. Not surprisingly, under such conditions, a good deal of highly inefficient investment took place. This is one important reason why, although overall rates of investment in Hungary have been reasonably high, the overall growth rate in the last decade has been very low.

Thus an important aspect of the transition to the market now underway is to ensure that investment funds are invested more wisely, with greater concern for the likely economic effectiveness of the funds assigned to any given project. Ensuring this is partly a matter of improving the functioning of the banking system (an issue beyond the scope of paper), partly to do with the provision of stronger incentives to select efficient investments, and partly a question of improving the quality of economic information available to investors and the suppliers of funds. This paper mainly addresses the last of these points.

In addition, under the new conditions, it can no longer be assumed that existing enterprises will all survive and grow as before. Instead, some enterprises will prove unable to adapt to the developing market environment and will go bankrupt instead of being privatised. Others will find that part of their business is viable and can be privatised as a separate economic unit, while the rest might have no future at all. Finally, some enterprises will be in good shape already, and be capable of privatisation as a whole, possibly through the medium of a joint venture or some other vehicle to bring in new investment, technology and management skills.

Privatisation, however, is likely to be a long drawn out process, extending over several years. For enterprises whose privatisation might be delayed for some time, the present effective owner, namely the relevant state agency (which may be the State Property Agency, but could be one of several other agencies or ministries, depending on the branch and the nature of the production concerned), is in a position not greatly different from that of the state under the old system of economic management. In particular, the "owner" has to decide whether a given loss-making firm should continue to receive subsidies to enable it to keep going (and under what conditions, and for how long), or whether it should be liquidated or otherwise restructured. Such decisions are, of course, simply another form of investment decision.

If the prevailing market prices are "correct", in the sense of reflecting the real opportunity costs to Hungary of the various goods and services used in production, and of the resulting outputs, then investment evaluation is relatively simple: for a given project one simply tabulates the inputs and outputs occurring in each period, attaches the appropriate price to each element in the table, and calculates the present value of the investment (using a suitable discount rate). The investment should then be accepted if the resulting present value is non-negative. All this is well known and conceptually simple, and such discounted cash flow (DCF) methods were even recommended (though not widely used) during Hungary's socialist period.

The problem is that for a highly open economy like Hungary, the relevant opportunity costs (at least for the traded sectors) are the relative world market prices encountered on Hungary's export markets. In an economy free from the sorts of distortion referred to above, the domestic prices of tradeables would more or less coincide with the world market prices (aside from the factor of the exchange rate, of course), and in such a case the use of domestic prices in investment evaluation would be essentially correct.

But in practice, even though substantial price liberalisation and trade liberalisation have occurred, and Hungary's tax system has been greatly simplified and reformed in line with western practice, many price distortions remain (resulting from the remaining differentiated taxes and subsidies, and the exploitation of domestic monopoly by some producers[1]). In our view, therefore, it remains necessary to evaluate the profitability of economic activity using a set of prices which differs from the existing domestic prices in important ways. The purpose of this paper is to explain how this should be done, to demonstrate the method by showing some detailed results for the Hungarian economy, discussing in some detail the policy implications of our approach. In this way we explain how the approach can be used to assist the country's economic administration.

The paper is therefore organised as follows. The next section outlines different approaches to assessing efficiency given distorted prices and then deals with specific issues to do with the necessary Hungarian data. *Section 3* explains the calculations that were carried out and describes the tables generated, while *section 4* comments on the results in some detail, comparing them both to earlier work on the same topic done in Hungary, and by related work by Hughes and Hare on other Central and Eastern European countries. *Section 5* considers how branches of the Hungarian economy are actually performing in the current recessionary environment and compares this performance to their estimated competitiveness. *Section 6* assesses how the Association Agreement between Hungary and the EC will effect the competitiveness of various branches. The final section concludes the paper.

2. Assessing the efficiency of production

The social profitability of producing a given product is defined as the net economic gain from production of that product when all outputs produced, and ma-

[1] The precise list of distorting taxes depends on the chosen year, of course. The results reported below mainly use data for 1990, but also attempt to project forwards in estimating the long run effect of the EC Association Agreement. Some indication of distortions in the Hungarian tax system is provided in the very detailed paper by *Révész and Zalai* (1992).

terial inputs and factors of production used, are valued at their social opportunity cost. The appropriate ways of assessing the social opportunity cost of production are described in the technical appendix, but the basic ideas are quite simple.

In an open economy with many price distortions, what is required is to value all the inputs and outputs in production in a consistent way. Products (branches) are classified into tradeable and non-tradeable categories. For a tradeable branch, the relevant opportunity cost is simply the world market price, appropriately measured (see below). Non-tradeables are treated as combinations of tradeables, non-tradeables and imported inputs. In this way, it is possible to calculate an indicator called the domestic resource cost (DRC), which in simple terms can be expressed as:

$$DRC_i = (\text{value added at domestic prices})_i / (\text{value added at world market prices})_i$$

where i refers to a tradeable good (branch). Low values of the DRC indicator correspond to the more competitive branches, since a low value implies that relatively few domestic resources of labour and capital are required to earn a dollar's worth of GDP measured at world market prices. High values correspond to uncompetitive branches. In extreme cases, when the denominator is negative, the DRC can be negative: this corresponds to the most uncompetitive branches of all.[2]

In an economy in equilibrium, the average DRC (and the cut-off point between uncompetitive and competitive branches) should be one. As we shall see below, this was not the case for Hungary in 1990.

To assess the efficiency of producing different products in Hungary we would ideally use current information on the technology available to each Hungarian enterprise. Such information is not however readily available. But if we identify products with branches of the economy we can exploit the availability of Hungarian sectoral input-output information to provide a picture of technology.

Hungarian statistical sources are currently in a state of transition. Consequently data for 1991 and 1992 are rather limited, and input-output data for these years are certainly not available yet. To assess the efficiency of different branches of the Hungarian economy we must therefore rely on historical data, with suitable adjustments. As a first approximation, we assume that the technology reflected in the most recently available input-output table for 1990 corresponds to Hungary's existing technology. It is also assumed that production possibilities are adequately represented by the Leontief technology of an input-output table. The 85 sector, 1990 input-output table used here is an RAS updated version of Hungary's 1986 input-output table. This method of updating uses information about row and col-

[2] Strictly speaking, there is a further possibility, namely that both numerator and denominator could be negative, in which case the DRC as just discussed is not very meaningful. Such cases did not occur for Hungary.

umn totals for the later years (1990), and the input coefficients for the earlier year (1986), to estimate the 1990 input coefficients. The method is not perfect, but it is the best available, and careful inspection of the estimated 1990 coefficients does not suggest that they are unreasonable: the estimates certainly pick up the main trends in technical coefficients (for details of the RAS method, see *Miller and Blair* 1985, ch. 8).

In order to calculate DRC indicators under various assumptions, we not only need the input-output data already referred to, but for the branches identified as tradeable we also require data on world market prices, or more exactly, on the ratios between world market and domestic prices for 1990. As discussed in the technical appendix, we effectively treat domestically produced products as being different from products in the same branch supplied by the world markets. In this case the alternative to production or use of one of the t traded products is one unit more or less export of that product. The elements of α, the vector of world to domestic price ratios for traded goods, should thus be calculated as ratios of fob export prices to domestic prices.

To calculate such ratios we must first define a world market. Given the collapse of Hungarian trade with other former rouble accounting countries and the growth of Hungarian trade with the "dollar accounting zone" it seems reasonable to identify the world market with the "dollar accounting market". Having defined a world market we could use either of two methods for compiling data on the ratios of fob export prices to domestic prices.

The first relies upon information on net export subsidies to calculate the margin between fob export prices and domestic prices. Such an approach assumes that export subsidies/taxes were used to compensate/charge domestic producers for the loss/gain incurred/achieved when selling products on world markets. The second method directly compares fob export prices to domestic producer prices, ideally for products within each sector sold on both markets.

For compiling data on Hungarian fob export prices we prefer not to rely upon the first approach because we believe that historically export taxes were not applied when financial gains were made through exports. We therefore try to make direct price comparisons. To do this we make use of information on 1988 "hard" currency transactions reported by enterprises. In the pre-reform Hungarian economy, for each "hard" currency transaction an enterprise made it was required to provide information on the domestic and international value of items sold. Such information provides estimates of fob export prices to domestic producer price ratios for products that were actually exported. If we assume that the world to domestic price ratios so recorded are also representative of these ratios for products that were not actually exported then the ratios recorded give an estimate of the vector, α.

We adjust the 1988 price ratios so calculated for domestic price inflation in each branch, average world market inflation and nominal exchange rate movements to give estimated 1990 world market prices.

Having defined the dollar accounting zone as the world market this raises the problem of how to value exports to and imports from the former rouble zone. There is no reason to believe that the implied fob export/cif import prices of these items valued at the official historical transferable rouble exchange rate bear any consistent relation to the corresponding dollar prices of the same products. We must therefore adjust the world market value of these by using a suitable adjustment factor. We use a factor of two for imports from the rouble zone. The value of two can be approached either by making use of the historical forint/rouble and forint/dollar exchange rates or by direct price comparison of the forint prices in dollar and rouble markets of a selection of similar products sold on both. On the basis of equivalent reasoning we use an adjustment factor of one and a half for exports to the rouble zone.[3]

3. Assessing the efficiency of production: results

Table 1 lists the 62 branches assumed, on the basis of recent trade data for Hungary, to produce tradeable products. For part of the analysis, it was useful to classify products into three groups: an unprocessed product group, a basic products group and a sophisticated products group. The assignment of each branch is also shown in *Table 1*, and the role played by this classification in the analysis is brought out later in this section.[4]

Table 2a provides domestic resource cost results based on the approach described above and in the technical appendix. All branches producing tradeable products are treated as traded branches. We comment on all results in the following section.

Under various international trade agreements, Hungarian exports to the world market are limited by a host of trade restrictions. Some of these are explicit quantitative restrictions, i.e. quotas. Others (e.g. voluntary export restraints, anti-dumping measures which force Hungarian exporters to accept high price rather than market share, and domestic production subsidies in Hungary's export markets which maintain the market share of domestic producers) are implicit quantitative restrictions. Whatever their nature these measures, if binding, limit Hungarian

[3] These rouble-dollar conversion rates may appear somewhat arbitrary and distorting. But it should be noted that (a) experimentation with different conversion rates showed that the results were not very sensitive to the assumptions made, and (b) the relative forint prices of exports to (or imports from) the rouble and dollar markets, based on official exchange rates, should already reflect the main differences in relative prices between different products (e.g as between Ikarus buses and food products).

[4] It could easily be argued that this sectoral classification is too mechanical. But most results are not sensitive to the precise assignment of a few branches, and useful analysis is impossible without some such classification.

Table 1
Tradeable branches in Hungary

Sector name	Number and quality classification	Sector name	Number and quality classification
Coal extraction	1 Unpro	Furniture	32 Soph
Oil/gas extraction	2 Unpro	Other timber prods	33 Basic
Bauxite extraction	3 Unpro	Paper	34 Basic
Other mineral extract	4 Unpro	Print/publishing	35 Soph
Iron and steel	5 Basic	Cotton industry	36 Basic
Aluminium	6 Basic	Flax/hemp/jute	37 Basic
Other metallurgy	7 Basic	Wool	38 Basic
Machinery and equips	8 Soph	Silk	39 Basic
Transport equipments	9 Soph	Haberdashery	40 Soph
Electrical appliances	10 Soph	Knitwear	41 Soph
Telecomm/vacuum prods	11 Soph	Leather and fur	42 Soph
Instrument engineering	12 Soph	Footwear	43 Soph
Metal products	13 Soph	Clothing	44 Soph
Bricks/tiles	14 Basic	Handicrafts	45 Soph
Lime and cement	15 Basic	Other manufact	46 Basic
Prefab building comps	16 Soph	Slaught/meat prods	47 Unpro
Asbestos cement	17 Basic	Poultry and eggs	48 Unpro
Insulating materials	18 Basic	Milk/milk products	49 Unpro
Pottery and china	19 Soph	Canning	50 Basic
Glass and glass prods	20 Basic	Flour-milling	51 Basic
Mineral oilprocessing	21 Basic	Baking	52 Basic
Gas	22 Basic	Sugar	53 Basic
Organ/inorgan chemics	23 Basic	Confectionery	54 Basic
Fertilizers	24 Basic	Vegetable oil	55 Basic
Plastics	25 Basic	Alcoholic drinks	56 Soph
Plastic products	26 Basic	Wine	57 Soph
Rubber products	27 Basic	Brewing	58 Soph
Pharmaceuticals	28 Soph	Soft drinks	59 Soph
Cosmetics	29 Soph	Tobacco	60 Soph
Boards/sawnwood prods	30 Basic	Agriculture	61 Unpro
Construction joinery	31 Soph	Forestry	62 Unpro

Note: Branches are classified into three categories—unprocessed products (Unpro), basic products (Basic), sophisticated products (Soph).

exports. The domestic use of a product facing a binding quantitative export restriction does not mean lower exports of that product. We should then treat inputs of products facing binding quantitative export restrictions as inputs of non-traded products. The results of *Table 2a* therefore require amendment to allow for this consideration.

Table 2a

DRC results for Hungary in 1990: unrestricted trade

SECTOR	DRC	SECTOR	DRC
1	0.52	32	1.26
2	0.93	33	0.93
3	0.63	34	0.71
4	3.85	35	1.72
5	1.38	36	1.05
6	0.91	37	0.86
7	−1.89	38	1.47
8	0.85	39	0.90
9	0.56	40	0.83
10	0.85	41	0.40
11	0.63	42	0.58
12	0.61	43	0.63
13	0.88	44	0.85
14	0.62	45	0.85
15	0.55	46	0.88
16	0.96	47	2.90
17	0.82	48	1.49
18	0.99	49	−11.75
19	1.21	50	1.59
20	0.94	51	1.65
21	−2.45	52	1.07
22	0.91	53	1.73
23	0.51	54	0.68
24	1.38	55	2.28
25	0.90	56	2.53
26	1.00	57	0.81
27	0.86	58	1.13
28	0.66	59	0.85
29	0.86	60	0.84
30	0.61	61	0.94
31	0.46	62	0.72

Note: all sectors shown here are assumed to be traded.

To make the necessary amendment we need to determine which branches face binding quantitative exports restrictions. Our information on quantitative exports restrictions, which we now describe, is derived from *Messerlin* (1992). This paper reports on the trade practices of OECD countries towards Hungary and other central and eastern European countries. Though Hungary is not itself a member of the OECD, the OECD countries include Hungary's major trading partners. Even by 1990 (i.e. prior to the collapse of the CMEA, and the subsequent initiation of economic reforms in the former Soviet Union) some 49 percent of Hungarian exports went to OECD countries. By the end of 1992 this figure could be over 75 percent. We thus treat the OECD as the world market.

Table 2b

DRC results for Hungary in 1990—with trade restrictions

SECTOR	DRC	SECTOR	DRC
1	0.53	32	1.27
2	0.94	33	0.94
3	0.63	34	0.71
4	3.78	35	1.72
5	1.45	36	1.66
6	0.91	37	0.86
7	−2.70	38	1.47
8	0.89	39	0.90
9	0.60	40	0.83
10	0.87	41	0.40
11	0.64	42	0.58
12	0.62	43	0.63
13	0.91	44	0.85
14	0.63	45	0.85
15	0.56	46	0.89
16	1.01	47	2.89
17	0.82	48	1.49
18	0.98	49	−14.85
19	1.21	50	1.59
20	0.94	51	1.65
21	−2.56	52	1.07
22	0.91	53	1.73
23	0.51	54	0.68
24	1.39	55	2.28
25	0.90	56	2.48
26	1.00	57	0.89
27	0.86	58	1.13
28	0.66	59	0.85
29	0.86	60	0.84
30	0.61	61	0.94
31	0.47	62	0.72

Note: the following tradeable branches are treated as non-traded: 5, 54, 57, 59, 60

Even though Hungary now benefits from Most Favoured Nation status with all OECD countries, certain quantitative restrictions on Hungarian exports remain. In particular measures have been maintained which restrict sensitive exports from Hungary as a CEEC5 (Hungary, Poland, CSFR, Romania and Bulgaria) member.

Products of particular sensitivity are defined as agricultural and food processed products, textiles and apparel, iron and steel industry and chemical products.

Exports of agricultural and food processed products face heavily subsidized competition from domestic producers in OECD export markets. The extent of this protection has been estimated by calculating "aggregate nominal assistance coefficients" for Hungarian agricultural exports. These coefficients estimate the difference generated by all forms of agricultural protection between cif import prices and domestic producers prices in Hungary's OECD export markets. Messerlin presents these coefficients as *ad valorem* equivalent nominal rates of protection. The coefficients show that the level of protection faced by Hungarian exporters of agricultural/processed food products is extremely high: it exceeds 100 percent for most OECD countries. Furthermore the coefficients show that with the exception of US and Japanese markets there have been significant increases in the level of support/protection received by domestic producers. Such protection we presume has been used to maintain the market share of domestic producers. Subsidies tend to be increasingly reinforced by import quotas, presumably as a response to the increasing cost of subsidisation. We shall assume that the combination of these measures means that Hungarian exports of agricultural/processed food products are subject to quantitative restriction.

Whether such export restrictions are binding is a different matter. We shall assume that agricultural/food processing branches shown to produce competitively face binding quantitative export restrictions: At the foot of *Tables 2b–2e* we note which products we assume to face binding export restrictions.

MFA quotas apply on certain Hungarian textile and apparel exports to OECD countries. The trade coverage ratios corresponding to these restrictions are however mostly significantly less than fifty percent. These figures obviously need be interpreted carefully because of the censoring effect of the restrictions. They do however indicate that many/most textile and apparel products can be exported free of quantitative export restrictions. Also for many textile/apparel products Hungary benefits from large quota allowances. Simultaneously quota utilization rates are low, lying around 60 percent. We therefore assume that textile and apparel products do not face binding quantitative export restrictions.

Over the 1980s the protection provided to OECD producers of iron and steel has evolved in form from voluntary export restraint to price regulation. In the US minimum prices are imposed through anti-dumping actions. In the EC, minimum prices have been introduced into quota arrangements on CEEC5 iron and steel exports to each of member states. Virtually all CEEC5 iron and steel exports are subject to such arrangements. We assume therefore that Hungarian exports of iron and steel face binding quantitative export restraints: Such measures force Hungarian producers to accept high prices for what they sell, and prevent them lowering prices to gain market share.

Table 2c

DRC results for Hungary in 1990—small quality adjustment

SECTOR	DRC	SECTOR	DRC
1	0.53	32	1.33
2	0.93	33	0.96
3	0.64	34	0.75
4	3.18	35	1.95
5	1.50	36	1.09
6	0.93	37	0.89
7	−2.87	38	1.51
8	0.93	39	0.93
9	0.62	40	0.93
10	0.93	41	0.43
11	0.66	42	0.64
12	0.64	43	0.68
13	0.99	44	0.88
14	0.66	45	0.89
15	0.59	46	0.92
16	1.11	47	1.23
17	0.87	48	1.07
18	1.02	49	1.75
19	1.28	50	1.27
20	0.97	51	1.31
21	−1.66	52	1.09
22	0.95	53	1.44
23	0.54	54	0.77
24	1.43	55	1.23
25	0.92	56	2.02
26	1.03	57	0.94
27	0.88	58	1.20
28	0.69	59	0.93
29	0.96	60	0.95
30	0.66	61	0.94
31	0.53	62	0.72

Note: 1. The following tradeable branches are treated as non-traded: 5, 54, 57, 59, 61
2. World to domestic price ratios were adjusted as follows: unprocessed products—unchanged; basic products—reduced by 3%; sophisticated products—reduced by 6%

The main instrument affecting Hungarian exports of chemicals has been anti-dumping regulation. When applied, this regulation has similarly forced Hungarian producers to accept high price rather than market share. The scope of such regulation is however limited. Most actions passed against Hungarian chemical exports were based on laws specific to non-market economies. Such laws no longer apply. Furthermore since 1985 the rate at which new anti-dumping measures have been implemented has decreased considerably. We therefore assume Hungarian exports of chemical products do not face binding quantitative restrictions.

Table 2b reports domestic resource cost calculations which treat inputs of iron and steel and specified agricultural/food processed products as non-traded products.

Table 2d

DRC results for Hungary in 1990—medium quality adjustment

SECTOR	DRC	SECTOR	DRC
1	0.53	32	1.40
2	0.93	33	0.98
3	0.64	34	0.77
4	3.08	35	2.19
5	1.55	36	1.11
6	0.93	37	0.90
7	−2.60	38	1.56
8	0.96	39	0.96
9	0.63	40	1.02
10	0.97	41	0.44
11	0.67	42	0.68
12	0.66	43	0.70
13	1.05	44	0.90
14	0.68	45	0.92
15	0.61	46	0.94
16	1.20	47	1.22
17	0.92	48	1.06
18	1.05	49	1.72
19	1.33	50	1.27
20	0.99	51	1.35
21	−1.27	52	1.11
22	0.98	53	1.48
23	0.56	54	0.81
24	1.47	55	1.26
25	0.94	56	2.17
26	1.06	57	0.97
27	0.88	58	1.28
28	0.70	59	0.99
29	1.04	60	1.01
30	0.69	61	0.93
31	0.56	62	0.72

Note: 1. The following tradeable branches are treated as non-traded: 5, 54, 57, 61
2. World to domestic price ratios were adjusted as follows: unprocessed products—unchanged; basic products—reduced by 5%; sophisticated products—reduced by 10%

The world price vector which lies behind the calculations of *Tables 2a* and *2b* is based on information about products actually exported. The crucial question in utilising such data is whether the average branch ratios of world to domestic prices obtained in this way are typical of the unobserved ratios for the branches to which they apply. An advantage in analyzing branch rather than enterprise data is that the relative magnitude of the errors associated with the use of data on perhaps untypical products is reduced. However this does not remove the problem of systematic biases.

If the exports of a branch to the world market were of higher than branch average quality and price differentials reflecting quality differences were compressed in the domestic economy then the branch world to domestic price ratios we use will be biased upwards. Since we believe such conditions prevailed historically we conclude that our price ratios are most likely to be biased upwards.

It is however difficult to quantify the extent of this bias without additional quality information. Indirectly, however, we can place an upper limit on the size of the bias. If we assume that in 1990 the alternative to producing any individual product was producing a basket of traded products made up according to 1990 production levels, then the 1990 shadow rate of exchange implied by the results of *Table 2b* is around 0.9. This figure corresponds to the idea that the forint was undervalued in 1990. (The forint has followed a path of marked real appreciation since 1990.) To maintain this implication, elements of the vector, α, can only be adjusted downwards to the extent that the estimated 1990 shadow rate of exchange remains less than one.

The degree of bias associated with the elements of α is likely to vary between branches. We cannot therefore make a uniform downward adjustment to the components of α. For largely unprocessed products, such as agricultural produce, slaughtered meats, and products of the extraction industries biases are likely to be small. These branches, we believe, produce relatively standardized products. For highly processed products such as instrument engineering and consumer products the biases involved are likely to be most significant. These branches produce a diverse group of products in terms of quality. It is likely to have been the better quality products which were exported to the dollar zone and domestic price differentials reflecting quality are likely to have been compressed. Inter-mediate degrees of bias are likely to affect basic products such as steel bars, basic chemicals, textiles yarns and sugar. This is the basis for the classification of products into three categories, shown in *Table 1*.

We consider the effects of three different adjustments to α. In the first adjustment we leave the world to domestic price ratios of unprocessed products unaltered. We decrease the world to domestic price ratios of basic products by 3 percent and decrease the world to domestic price ratios of sophisticated products by 6 percent.

Table 2e

DRC results for Hungary in 1990—large quality adjustment

SECTOR	DRC	SECTOR	DRC
1	0.52	32	1.51
2	0.93	33	1.02
3	0.63	34	0.81
4	2.93	35	2.68
5	1.63	36	1.14
6	0.94	37	0.92
7	−2.31	38	1.62
8	1.01	39	0.99
9	0.65	40	1.18
10	1.03	41	0.47
11	0.69	42	0.75
12	0.68	43	0.74
13	1.15	44	0.94
14	0.71	45	0.97
15	0.63	46	0.98
16	1.35	47	1.20
17	0.96	48	1.05
18	1.10	49	1.69
19	1.41	50	1.27
20	1.02	51	1.42
21	−0.95	52	1.15
22	1.03	53	1.54
23	0.58	54	0.87
24	1.55	55	1.29
25	0.96	56	2.43
26	1.09	57	1.00
27	0.89	58	1.41
28	0.73	59	1.09
29	1.18	60	1.11
30	0.74	61	0.92
31	0.62	62	0.71

Note: 1. The following tradeable branches are treated as non-traded: 5, 54, 57, 61
2. World to domestic price ratios were adjusted as follows: unprocessed products—unchanged; basic products—reduced by 8%; sophisticated products—reduced by 16%

In the second adjustment the corresponding figures are 0.5 and 10 percent respectively. In the third scenario these figures are 0.8 and 16 percent respectively.[5] The degree of initial bias assumed to exist in α therefore increases between adjustments.

[5] Ideally, of course, it would be best to conduct the analysis with individual products or enterprises rather than with entire sectors, since within-sector variation is likely to be substantial. But data limitations prevented us from doing this in the present paper.

The adjustments factors have, however, been chosen to maintain the implication of an undervalued forint. Results corresponding to the different adjustments to α are reported in *Tables 2c, 2d* and *2e.*

4. Discussion of results

The shadow rates of exchange implied by the results in *Tables 2a* to *2e* vary between 0.91 and 0.97. This implies that in 1990 the forint was under-valued. As discussed this is a reasonable finding. Indeed we shall argue in the next section that we may have underestimated the efficiency of certain branches. The implied shadow rate of exchange may then be somewhat lower than suggested.

The variation of domestic resource costs can meaningfully be described as significant. The least competitive branch in each set of results shows a negative domestic resource cost. The value at world prices of the output produced by such a branch is less than the value at world prices of the intermediate inputs used by that branch. This implies that even if the opportunity cost of domestic factors were zero the branch reduces GDP valued at world prices. The most competitive branch in each set of results shows a small positive domestic resource cost of between 0.3 and 0.5. A branch showing such a domestic resource cost covers the cost of the domestic factors it employs and makes a further surplus to add to GDP valued at world prices. The implication of such a distribution of domestic resource costs is that there are large gains to be made from a redistribution of domestic factors amongst branches.

The variation of branch domestic resource costs within individual sectors is also "significant". That is to say within individual sectors some branches appear to be competitive whilst others not. This variation suggests that branch results might themselves be subject to significant internal variation at an enterprise/plant level. Our results thus offer only a guide to where on average enterprises/plants are likely to be competitive.

To be more specific we consider results by sector. The extraction sector, a medium sized sector in terms of 1990 production, shows output weighted domestic resource costs of 0.76, 0.76, 0.76, 0.76 and 0.75 over the five sets of results. The corresponding shadow rates of exchange are 0.91, 0.92, 0.95, 0.96, 0.97. The sector therefore consistently appears to be competitive. The sector appears most competitive when the quality adjustment to α is made because we assume the sector's products are "unprocessed" products. The adjustment for export restricted products have little effect on the apparent competitiveness of the sector because the sector is a relatively average consumer of iron and steel and agricultural/processed food products. Within the sector coal and bauxite extraction are the most competitive branches. Oil/gas extraction is of only average competitiveness whilst other extraction appears to be uncompetitive. The coal and oil/gas branches are the most significant branches within the sector in terms of 1990 production.

The metallurgy sector, another medium sized sector, shows output weighted domestic resource costs of 1.23, 1.29, 1.33, 1.36 and 1.41 over the five sets of results. The sector therefore consistently appears to be uncompetitive. The sector's apparent competitiveness changes little over quality adjustments to α because the products of the sector are all assumed to be "basic" products. Within the sector aluminium production is just competitive, whilst iron and steel production and especially other metallurgy are uncompetitive. Other metallurgy consistently shows a negative domestic resource cost. Because the sector itself consumes a relatively large amount of iron and steel, treating inputs of iron and steel as inputs of non-traded inputs noticeably worsens the competitiveness of the sector in the second set of results. Iron and steel is the significant branch within the sector in terms of 1990 production.

The engineering sector, the second largest sector in terms of 1990 production, shows output weighted domestic resource costs of 0.72, 0.75, 0.78, 0.81 and 0.84. The sector therefore consistently appears to be competitive. The sector's relatively large consumption of iron and steel explains why its apparent competitiveness worsens between the first and second set of results. The adjustments to α tend to make the sector look less competitive because we assume many of its products are sophisticated products. Within the sector transport equipment, telecommunications and vacuum products, and instrument engineering appear to be the most competitive branches. Machinery and equipment, electrical appliances and metal products are less competitive. Metal products appear to be uncompetitive in the final sets of results. All branches are significantly sized in terms of 1990 production.

The construction materials sector, a relatively small sector in terms of 1990 production, appears to be another consistently competitive sector. It shows output weighted domestic resource costs of 0.81, 0.83, 0.86, 0.89, 0.94 over the five sets of results. The apparent efficiency of the sector changes little when inputs of iron and steel/certain agricultural/processed food products are treated as inputs of non-traded products. The sector is an "average" consumer of such export restricted products. The quality adjustment to α worsens the apparent competitiveness of the sector because some of its products are assumed to be sophisticated products. In the final set of results the sector therefore appears to be only just competitive. Within the sector the bricks/tiles and lime/cement branches are consistently shown to be most efficient whilst the branches producing sophisticated products, i.e. pottery, china and prefabricated building components, appear increasingly uncompetitive over the sets of results. Brick/tiles, lime/cement and glass/glass products branches are the most significant in terms of 1990 production.

The chemicals sector, a large sector in terms of 1990 output, shows output weighted domestic resource costs of 0.89, 0.89, 0.94, 0.97, 1.02. The sector therefore appears to be just competitive in the initial results but appears to be marginally uncompetitive in the last two sets of results. Given that we may have underestimated the shadow rate of exchange it seems reasonable to conclude that the sector as a whole is marginally uncompetitive. The adjustment to α worsens the apparent competitiveness of the sector because some of its products are assumed to be sophisticated products. Also a major input of the sector, and the oil processing sub-branch in particular, is unprocessed oil. The assumed world price of oil increases relative to other world prices in the later results because it is assumed to be an unprocessed product. The adjustment for non-traded tradeable inputs has a minor effect on the apparent competitiveness of the sector. Within the sector there is a wide deviation of profitability. The branches producing fertilizers, plastic products and processed oil appear uncompetitive. Oil processing consistently shows a negative domestic resource cost. Pharmaceuticals, rubber products and organic/inorganic chemicals all appear to be competitive. Oil processing, gas, plastics and pharmaceuticals are the significant branches in terms of 1990 production.

The consumption goods production sector, a large sector in terms of 1990 production, shows output weighted domestic resource costs of 0.88, 0.87, 0.92, 0.96 and 1.02 across the five sets of results. The results are thus mixed but indicate that when the quality adjustment to α is made, the sector is uncompetitive. Many of the products of the sector are assumed to be "sophisticated". It seems reasonable to consider the last set of results as best reflecting the competitiveness of the sector because the quality bias in the original α may be largest within this sector. The adjustment for export restrictions on iron and steel makes the sector look slightly more competitive because the sector consumes a relatively small amount of iron and steel. Within the sector the branches producing boards/sawnwood products, construction joinery, paper, flax/hemp/dute, knitwear, leather and fur products and footwear appear to be most competitive. Furniture production, printing, cotton production and wool production consistently appear to be uncompetitive. Amongst the branches paper, cotton and clothing production and printing are most significant in terms of 1990 production.

The food processing sector, a significant sector in terms of 1990 production, shows output weighted domestic resource costs of 1.66, 1.63, 1.24, 1.25 and 1.27 across the five sets of results. The first two figures, derived without the quality adjustment to α, suggest the sector to be very uncompetitive. When the quality adjustment is made the sector looks rather better though it still appears to be uncompetitive. This improvement occurs because of our treatment of the sector's agricultural inputs. As we discuss in the next section the quality adjustment to α makes agriculture an apparently competitive sector. Without the quality adjustment it appears to be uncompetitive. This means that in the first and second set of results agricultural inputs are considered as inputs of traded products but in the third, fourth, and fifth set of results they are considered as inputs of non-traded products. By considering agricultural inputs as non-traded inputs their efficient production is "vertically integrated" into the production of food processed products. This considerably improves the apparent performance of the food processing branches.

Within the sector, wheat processing and wine production consistently appear to be competitive sectors. Slaughtering/meat products, milk and milk products, canning, flour milling, vegetable oil, sugar production and spirits production consistently appear to be uncompetitive. It is however questionable whether this subsectoral breakdown is meaningful. Some two-thirds of the food processing sector inputs come from the agricultural sector. These inputs cover a wide diversity of products. There is likely to be a wide diversity in the world to domestic price ratios of these products. We, however, treat agriculture as one aggregated sector and therefore assign a single world to domestic price ratio to all these products. This distorts the real input costs at world prices of the different food processing sectors. Similar effects result when we treat all inputs of agricultural produce as inputs of non-traded products.

Considering then the efficiency of the agriculture sector, the largest sector in terms of 1990 production, we note the sector shows domestic resource costs of 0.940, 0.944, 0.937, 0.928, 0.916 across the five sets of results. When the quality adjustment to α is made the sector therefore appears to be a competitive sector. The competitiveness of the sector improves when the quality adjustment is made because agricultural output is considered to be "unprocessed" output. The adjustment for export restricted products marginally improves the competitiveness of the sector because the sector consumes little iron and steel. Considering agricultural inputs as inputs of non-traded products in the third, fourth and fifth set of results has no effect because the corresponding vertical integration is effectively vertical integration with a sector of identical efficiency, i.e. itself.

The forestry sector shows domestic resource costs of 0.72, 0.72, 0.72, 0.72, 0.71 and therefore consistently appears to be competitive. The sector produces an unprocessed product by assumption and consumes few inputs from sectors other than itself.

We conclude this section by remarking briefly on some comparisons of these results with (a) earlier Hungarian work on DRC estimation, and (b) recent work on other central and eastern European countries.

On (a), some very interesting work on the estimation of DRCs was carried out in Hungary using the detailed, 1981 input-output table; this work was published in *Ámon et al.* (1985). Although the precise numbers are not the same as those found in the present study, there are some striking similarities in the results obtained, in that the rankings of sectors by DRC in the two studies were very highly correlated. Methodologically, there are a few differences between this earlier Hungarian work and the present one. Aside from being more up to date, the present work also takes account of future developments in Hungary's trading environment (via the EC Association Agreement), and can be related to parallel studies of other countries in the region as indicated under (b), below. The treatment of mark-ups in non-traded sectors is different between the two studies, the 1985 paper retaining the mark-ups from the original input-output data while this one, in effect, treats non-traded goods as bundles of traded goods and factors, integrating them with the tradeable sectors which use them. In practice, this distinction turns out to have a very small effect on the results, however.

On (b), *Hughes and Hare* (1991, 1992a, 1992b) have computed DRCs and other indicators of competitiveness for Bulgaria, Czechoslovakia, Hungary, Poland and the former USSR. *Senik-Leygonie and Hughes* (1992) have carried out more detailed calculations for the former USSR and its fifteen constituent republics, while *Hare and Fomin* (1992) have done similar calculations for Romania. Aside from establishing the feasibility of the analysis, the results obtained in these papers have some interesting features. First, for all countries there are some very unprofitable branches, and some profitable ones; second, the most profitable branches appear to be different in each country, so that their industrial structures are complementary rather than competitive; third, the food industry and the most energy intensive sectors perform badly almost everywhere; lastly, much of the trade that was being conducted in the late 1980s was no more efficient than output as a whole, implying that there was scope for substantial efficiency gains as trade adapted in the direction of each country's comparative advantage. None of these other papers, however, calculated profitability indicators in the presence of different forms of trade distortion as is done in this paper.

5. Recent trends in production and exports

Since 1988 economic reform has proceeded rapidly in Hungary. 1988 saw tax reform and extensive price liberalization. 1989 saw import liberalization and extension of export licenses. In 1990 the communist party lost parliamentary and local elections and privatisation accelerated. 1991 saw import and export liberalization largely completed, as well as drastic cuts in subsidies to firms and households. Also in that year rouble accounting was transformed into dollar accounting with respect to trade. We therefore might expect to see, especially post 1990, competitive sectors expanding in terms of production and more especially exports, with uncompetitive sectors contracting. The picture is not, however, quite so simple. The costs of economic adjustment and the collapse of COMECON trade have meant that in the short term the size and the composition of "local" demand has changed significantly. In the existing recessionary environment, the overall production of sectors, when considered alone, is therefore a poor indicator of how they are performing.

We may, however, interpret changes in sectoral sales to the domestic market plus sales to the rouble accounting zone as describing changes in "local" demand conditions. That is to assume that in the current recessionary environment "local" sales are "local" demand led. We may then interpret changes in sales to the dollar accounting zone as describing how sectors are coping with the "imposed" levels of "local" demand.

Table 3

Changes in sales, 1990–92, by sector

Sector	Percentage change in rouble zone plus domestic sales as forecast by Hungarian Statistical Office: 1990–1992	Percentage change in dollar zone sales as forecast by Hungarian Statistical Office: 1990–1992
Extraction	−2.2	−31.6
Metallurgy	−22.2	−14.9
Engineering	−37.9	+41.6
Construc. good manu.	−33.9	+52.8
Chemicals	−17.1	+25.7
Consumpt. good manu.	−18.1	−0.7
Other industry	−14.6	+160.0
Food processing	−15.8	+45.1
Agriculture	−8.9	+19.8
Forestry	−6.6	+6.7
All sectors	−18.2	+22.0
All sectors except forestry and extraction	−19.3	+22.6

Table 3 provides the relevant data. *Column 2* of the table describes differences between 1990 "local" sales of sectors at 1988 prices and expected 1992 "local" sales of sectors at 1988 prices. 1992 expectations are obtained from forecasts provided early in 1992 by the Hungarian Statistical Office. These forecasts are based on actual 1991 sales. We do not question the accuracy of the forecasts, since they are only used in an illustrative way. *Column 3* of the table describes differences between 1990 dollar exports of sectors at 1988 prices and expected 1990 dollar exports of sectors at 1988 prices.

The figures show that the extraction sector, an apparently very competitive sector according to domestic resource cost analysis, appears to face favourable local demand conditions. Rouble zone exports plus domestic sales have remained roughly constant. This compares to an industrial average fall in "local" sales of some 18 percent. One might then expect the sector's exports to have remained roughly constant. Dollar exports are shown, however, to have decreased significantly in percentage terms. But this is somewhat misleading because exports of the sector start from a very small base. Decreases from a small initial figure tell us little. A better indicator of how the sector is performing is to note that the gross production at constant prices of the sector is expected to remain at its 1990 level in 1992. This compares to an economy-wide average decrease of some 9 percent. The sector therefore does appear to be performing well. Also it has been suggested that expansion of exports may well be limited as the sector currently operates close to capacity.

Like extraction, dollar exports of the products of forestry have not increased significantly. Like extraction this is surprising because the sector is competitive according to our results. Like extraction, however, the sector faces relatively favourable local demand conditions. Furthermore, like the extraction sector, forestry may currently be operating at capacity: like extraction its gross production at constant prices has remained roughly constant between 1990 and 1992. The sector therefore does in fact appear to performing well.

The metallurgy sector appears to face marginally better than average local demand conditions. Its dollar export sales have, however, fallen considerably suggesting a weak performance. This is what we would expect from the competitiveness results.

The engineering sector appears to face very weak local demand conditions. Being an apparently competitive sector we would thus expect it to be switching markets and rapidly increasing its dollar zone exports. This indeed appears to be the case. Similar results and comments apply for the construction materials production sector.

The chemicals sector, a marginally competitive sector is performing somewhat better than might be expected. Local sales appear to be slightly more buoyant than average domestic sales. Dollar export sales have also increased at an above average rate.

We can, however, explain these results by separating the sector into oil processing and non-oil processing chemicals. The oil processing branch, the most significant in terms of 1990 production, shows negative domestic resource costs and therefore contributes greatly to the overall uncompetitiveness of the sector. The non-oil processing branches show output weighted domestic resource costs of around 0.9 and therefore show approximately average competitiveness. An index of industrial output at constant prices shows the oil processing sector to have produced 87.4 percent of its 1990 output in 1991. This compares to an all industry average of 78.5 percent. Domestic sales of the branch for the first three months of year are 99.7 percent their level for the corresponding period of 1991. This compares to an industry average of only 75.1 percent. Together these data suggest that local demand for processed oil is strong. This being the case, then non-oil processing chemicals must face weak local demand conditions. The relatively good export performance of the chemicals sector as a whole thus presumably reflects an average sector, namely non-oil processing chemicals, coping with weak local demand. Furthermore dollar exports of oil are performing well. This we suggest results from transitory demand for Hungarian processed oil from other CEEC5 countries as they switch from Russian supplies of processed oil for dollar zone supplies of processed oil.

Consumption good manufacturing faces average levels of domestic demand. The sector has not, however, managed to switch sales to the dollar zone, with dollar exports actually falling. This we would expect from our competitiveness results.

Agriculture, an apparently just competitive sector, faces relatively very favourable local demand conditions. It is therefore not surprising that its dollar zone exports, though growing, are growing at less than the average rate. Growth may also be limited by capacity.

The food processing sector, unlike other sectors, does not perform as we would expect. Our domestic resource cost results suggest the sector to be uncompetitive. The performance of the sector is however good. Domestic demand is apparently strong and dollar zone exports are expected to increase at an above average rate. Indeed the sector's dollar zone export performance is second only to that of the construction goods production sector.

It is still possible however that in 1990 on average the sector was uncompetitive. Improvements in its efficiency over 1990 and 1991/1992 may subsequently have made the sector competitive. The sector's domestic resource cost reads around 1.2 in the last three sets of results. From a domestic resource cost of 1.2 it would take an increase in domestic factor productivity of around 20 percent to make the sector just competitive. Data on sectoral domestic factor productivity suggest that productivity in the food processing sector has increased between 1990 and 1991 at a rate of about 7 percent above the national average. If this were repeated in 1992 on top of improvements over 1990 then much of the improvement in productivity necessary to make the sector competitive would have occurred. Early data for 1992 indeed suggests relative productivity improvements to be continuing. (There does not seem to be a concurrent increase in the efficiency of materials use within the sector which is expected to stay constant at constant prices. This corresponds to the economy average.)

A possible additional explanation for the good performance of the sector is that we have underestimated the current fob export prices of processed food products. This would be the case if the food processing fob export price has increased since 1988 relative to the fob export price of other products. There is reason to believe that this is the case. In 1988 some 60 percent of food processed products exported to the dollar accounting zone were exported to the EC. However it was only over the years 1988 to 1990 that a cooperation Agreement signed between the EC and Hungary came into force. This effectively gave Most Favoured Nation (MFN) status to Hungary. Before implementation of this the EC denied Hungary MFN treatment on a certain exports. In particular, exports of agricultural and processed food products were subject to additional tariff and quota restrictions. The removal of such additional tariffs means that achievable fob export prices on processed food and agricultural exports will have increased since 1988. The effect of this is to make the food processing sector look less competitive than it should look.

It should be noted that the true 1990 shadow rate of exchange will be lower than indicated if we have underestimated the efficiency of the food processing and agricultural sectors.

6. Implications of the Association Agreement

The European Community is Hungary's most important partner in trade. Estimates suggest that over 50 percent of Hungarian exports will be sent to the EC in the long term (*Collins and Rodrick* 1991; *Rollo and Stern* 1991). In November 1991 the Association Agreements between the EC and the CSFR, Hungary and Poland were initialled after lengthy and sometimes difficult negotiations. The agreements are an attempt by EC members to bring together existing economic relations with the Central Europeans concerning trade and aid and embed them in the wider aim of European economic integration and political cooperation. The agreements await full ratification by EC member states and by Hungary, Poland and the CSFR, but an interim agreement involving all trade provisions of the Association Agreements entered into force in March 1992.

As trade with the EC is liberalised tariff reductions will increase average fob export prices. Also relative fob export prices will change with respect to each other. This means that the long term competitiveness of sectors will differ from their current competitiveness. Also, quota reduction/elimination will affect competitiveness.

To assess how these changes may effect competitiveness we note that the agreements seek to eliminate EC import tariffs on most products by 1996. The same applies for quantitative restrictions. "Most products" means products other than processed food and agricultural products. Significant quota restrictions on agricultural and processed food products will remain at least until 1996. Tariffs on EC imports of agricultural and processed food products will be reduced by a pre-determined percentage each year. The average overall reduction seems to be around 75 percent.

Our estimates of existing EC import tariffs are given in *Table 4 column 2.* The figures are based on estimates of sectoral average *ad valorem* EC import tariffs provided by Messerlin (1992) combined with Cooperation Agreement import tariff data.

We recalculate domestic resource costs accounting for the effect of expected tariff and quota reductions. We equate the EC with the world market and assume that Hungarian exporters receive the full benefit, in terms of the fob export prices they receive, of complete tariff elimination on exports of non agricultural/processed

Table 4

Impact of the EC Association Agreement on competitiveness

Sector	Estimated EC MFN tariff expressed as ad valorem rate	DRC	Sector	Estimated EC MFN tariff expressed as ad valorem rate	DRC
1	0.0	0.53	32	6.0	1.34
2	2.0	0.91	33	5.3	0.95
3	0.0	0.64	34	7.6	0.69
4	0.0	3.34	35	6.1	1.95
5	4.8	1.34	36	11.0	0.98
6	5.0	0.91	37	5.0	0.88
7	3.0	−1.94	38	11.0	1.33
8	4.1	0.91	39	7.0	0.89
9	6.1	0.58	40	12.3	0.82
10	5.8	0.91	41	12.3	0.41
11	5.8	0.66	42	4.7	0.66
12	8.3	0.63	43	10.9	0.65
13	5.8	0.95	44	12.3	0.86
14	4.0	0.64	45	7.8	0.88
15	4.0	0.57	46	7.8	0.86
16	4.0	1.10	47	19.0	1.06
17	4.0	0.84	48	16.0	0.98
18	4.0	1.00	49	19.0	1.37
19	8.4	1.23	50	23.0	1.14
20	8.3	0.90	51	10.0	1.15
21	4.6	−2.32	52	12.0	0.97
22	2.0	0.99	53	35.0	0.92
23	6.2	0.51	54	17.0	0.59
24	6.2	1.33	55	6.0	1.19
25	8.9	0.87	56	21.0	1.69
26	8.9	0.96	57	21.0	0.86
27	5.9	0.86	58	21.0	0.96
28	6.2	0.69	59	6.0	0.96
29	6.2	0.96	60	7.4	0.92
30	5.3	0.66	61	9.3	0.84
31	5.3	0.53	62	9.3	0.67

Note: the following tradeable branches are treated as non-traded: 54, 57, 61

food products. We similarly assume they receive the full benefit of a 75 percent reduction in tariffs on exports of agricultural and processed food products. We treat the effect of remaining quantitative restrictions on EC imports of agricultural/processed food products as before. We make the quality adjustment to α corresponding to *Table 2d*. The corresponding results are presented in column three of *Table 4*. The results describe the most extreme potential effect of the Association Agreement because the EC is really only part of Hungary's "world market".

The shadow rate of exchange implied by the results of *Table 4* is 0.871. This compares to a shadow rate of exchange of 0.96 implied by the results of *Table 2d*. The output weighted sectoral domestic resource indicators corresponding to the results are 0.749 for the extraction sector, 1.215 for the metallurgy sector, 0.758 for the engineering sector, 0.831 for the construction materials production sector, 0.903 for the chemicals sector, 0.880 for the consumption goods production sector, 1.067 for the food processing sector, 0.836 for the agricultural sector, and 0.669 for the forestry sector. The corresponding results for *Table 2d* were 0.756, 1.359, 0.806, 0.888, 0.956, 1.251, 0.928 and 0.717 respectively.

It therefore appears that the sectors that will benefit most from the Association Agreement are forestry, agriculture and food processing. Not surprisingly these are the sectors currently facing the largest tariffs. Given that we believe the efficiency of the agricultural and food processing sectors is underestimated the results suggest that all three of these sectors may have a profitable future (It is not surprising to find that those sectors which have faced particularly large tariffs are competitive). The competitiveness of the extraction sector appears to worsen under the new world price vector. The sector, however, remains competitive. Other sectors' competitiveness seems little altered by alterations to the world price vector. Metallurgy, consumption goods production and chemicals sectors therefore appear to continue to face difficult circumstances. Engineering continues to be competitive.

At a sub-sectoral level, the branches we expect to benefit particularly from the Association Agreement are iron and steel, cotton, wool, haberdashery, knitwear, slaughtering/meat products, milk processing, baking, sugar, cereals, alcoholic drinks and brewing. Branches expected to do relatively badly from the Association Agreement are all extraction branches, aluminium production, electrical appliances and telecommunication/vacuum engineering, gas production, pharmaceuticals and rubber products.

7. Conclusions

This paper has developed a methodology for assessing the international competitiveness of different industrial branches, and has applied the methodology to Hungary, using data estimated for 1990 (input-output table, vector of world to domestic price ratios). Because of uncertainties about the proper way to treat certain trade restrictions still applicable to Hungary in 1990, vectors of domestic resource costs were calculated using different assumptions: initially assuming that no trade restrictions applied, and then taking into account restrictions in a few branches, and treating these branches as if their output was non-tradeable. In addition, the treatment of quality in estimating the world to domestic price ratios could be questioned. In order to allow for possible differences, three calculations were carried out using world to domestic price ratios incorporating small, medium or large quality adjustment factors.

Changes in output and sales in various markets were examined in relation to the evidence provided by the estimated DRC indicators, to assess how far these indicators could be used to predict actual changes. With some qualifications, the observed changes in sales could be understood reasonably well in the light of the DRC indicators. Finally, the effect of the Association Agreement with the EC was examined, to assess how far it was likely to change the competitive position of Hungary's industries. It turned out that there were gainers and losers.

The analysis provides a useful starting point for more detailed analysis which could be regionally-based or enterprise-based. It also provides initial guidance both for trade policy and for industrial policy in Hungary, in the sense that it reveals the desirable directions in which Hungary's industrial structure should be adjusting, in order to establish the country's proper place in the European division of labour. In a fuller analysis, though, it would be essential to focus upon the enterprise rather than the sector as the basic unit of investigation. This is partly because concrete decisions about restructuring and privatisation always involve firms rather than sectors; and partly because within any branch, there is likely to be a wide range of performances among the constituent firms. Thus even in a competitive branch, some firms will exhibit very poor performance while other perform very strongly. In this sense, therefore, the branch-based analysis of this paper can only serve as a starting point for further work.

Technical appendix[6]

Define traded products as those whose production either leads to corresponding exports or corresponding import substitution. Define non-traded products as those whose production does not lead to corresponding exports or import substitution. The social profitability associated with production of the j^{th} traded product (NSP_j) may then be written as:

$$NSP_j = (U_j - M_j)e - \Sigma F_{sj} v_s \tag{1}$$

where U_j is the value at fob export/cif import prices in domestic currency of the j^{th} product produced, M_j is the value at fob export/cif import prices in domestic cur-

[6] The method of calculation set out below is similar to that explained in Hughes and Hare (1991), but some important details are different, reflecting specific Hungarian conditions as well as our desire to treat trade restrictions properly in this paper. Hence the inclusion of this appendix is not a needless repetition of material already published elsewhere.

rency of traded inputs used directly and indirectly in production of the j^{th} product, e is the shadow cost of foreign exchange expressed as a ratio of domestic currency to domestic currency, F_{sj} is the domestic value of domestic factors employed directly and indirectly in production of the j^{th} product, and v_s is the shadow cost of the s^{th} domestic factor expressed as a ratio of domestic currency to domestic currency.

Indirect uses of traded inputs and domestic factors occur when non-traded products whose production involves the use of traded products and domestic factors are used in the production of traded products. NSP_j therefore effectively considers the profitability of producing the j^{th} traded product in a vertically integrated sector encompassing production of final output and corresponding non-traded inputs.

The domestic resource cost (DRC) associated with production of the j^{th} traded product (DRC_j) is another measure of social profitability. It is defined as the domestic factor cost incurred in earning a unit of net foreign currency through production of the j^{th} product. It may thus be written as:

$$DRC_j = \Sigma f_{sj} v_s / (U_j - M_j) \tag{2}$$

DRC_j is derived by setting NSP_j to zero and solving for e. When NSP_j is zero, DRC_j is thus equal to the shadow cost of foreign exchange. Similarly when NSP_j is positive, DRC_j is less than the shadow cost of foreign exchange When NSP_j is negative, DRC_j is greater than the shadow cost of foreign exchange. The lower the domestic resource cost indicator therefore the more profitable the associated production. Note that in extreme cases, the DRC can be negative: this occurs when M_j exceeds U_j implying that the value (at world market prices) of direct and indirect material is greater than the value at world market prices of the corresponding output.

The advantage of using the domestic resource cost indicator to assess social profitability lies in the fact that the market exchange rates may be significantly different from the shadow exchange rate. If this is the case, then to assess the social value of $(U_j - M_j)$ the social profitability indicator relies on the provision of an estimated shadow rate of exchange. The domestic resource cost indicator avoids such reliance by assessing profitability independently of any assumed shadow cost of foreign exchange.

Suppose that the economy has an input-output flow matrix W. We can distinguish branches according to whether they produce "traded" products or "non-traded" products. We can then partition W into traded and non-traded branches, as shown in (3):

$$W = \begin{array}{cccc} \left(\begin{array}{cc} a^{TT} & a^{TN} \\ a^{NT} & a^{NN} \end{array} \right) & \begin{array}{cc} c^T & e^T \\ c^N & e^N \end{array} \\ \begin{array}{cc} m^T & m^N \\ v^T & v^N \end{array} & \end{array} \tag{3}$$

where a^{FG} is the $f \times g$ input-output flow matrix describing flows of outputs evaluated at domestic producer prices from the f branches identified as group F to the g branches identified as group G (F,G = N or T), c^F is the $f \times l$ domestic final demand vector representing domestic demand for products of the f branches identified as group F at domestic producer prices, e^F is the $f \times l$ export demand vector representing export demand for products of the f branches identified as group F at fob export prices, m^F is the $l \times f$ import flow vector describing use of imports by the f branches identified as group F at cif import prices and v^F is the $l \times f$ value added vector showing value added in production in the f branches identified as group F. This procedure therefore defines value added as output at producer prices minus inputs valued at producer prices.

Dividing column components of the "a/m/v" block of W by corresponding gross output gives the corresponding "technical" coefficient matrix. Dividing row components of the "c, e" block of W by corresponding gross outputs gives the corresponding "use" coefficients. We shall denote the components of the resulting coefficient matrix, U, by using upper case letters. Thus, for instance, the matrix A^{TT} denotes the input-output coefficient matrix describing use of the t traded products by the t traded branches and E^T represents the shares of export sales in total sales of traded branches.

Now to analyze the efficiency of traded product production it is necessary first to calculate the domestic value of non-traded products used directly and indirectly in the production of traded products. Consider, then, the production of unit domestic value output in the t traded branches. The corresponding domestic material balance equation for production of non-traded products is:

$$X^N - A^{NT} - A^{NN}X^N = 0 \tag{4}$$

where X^N is the n by t matrix whose i^{th} column describes the domestic market value of non-traded products used directly and indirectly in the production of unit domestic value output in the i^{th} traded branch. Solving this we find:

$$X^N = Z^N A^{NT} \tag{5}$$

where

$$Z^N = (I - A^{NN})^{-1} \tag{6}$$

Now let us use the notation "$U - M$" to represent the row vector of length t describing net foreign currency earnings associated with production of unit domestic value in all traded branches. Taking into account that exports are already valued at fob export prices we may then calculate "U" as:

$$U = \alpha(I - < E^T >) + \delta < E^T > \tag{7}$$

where α is the row vector of length t whose i^{th} element is ratio between the fob export/cif import price, in domestic currency, of the i^{th} traded product and the domestic producers' price of that product and where δ is the unit vector of length t.

We can similarly calculate "M", using the formulae for X^N derived in equation (5), as:

$$M = \alpha A^{TT} + \alpha A^{TN} Z A^{NT} + M^T + M^N Z A^{NT} \tag{8}$$

Subtracting "M" from "U" (using (7) and (8)) then gives "$U - M$", the net foreign currency earnings vector. Note that in this derivation we have separated imported inputs from domestically produced inputs and valued them directly at world prices. The need for such an approach in based on the assumption that imported inputs were different products to domestically produced inputs. This assumption reflects a view that historically the reason for importing foreign products into the Hungarian economy was because they displayed qualities unavailable in domestically produced outputs.

Let us use notation "$\Sigma F_s v_s$" to identify the row vector of length t describing the domestic factor costs associated with production of unit domestic value in all traded branches. If it were the case that market costs of domestic factors were undistorted and that branches just covered costs then this vector would correspond to the row vector of length t describing the value added directly and indirectly in production of unit value in the t traded branches:

$$\Sigma F_s v_s = V^T + V^N Z^N A^{NT} \tag{9}$$

It is unrealistic, however, to suppose that the stated assumptions hold exactly. As mentioned already, we believe the cost of capital was historically distorted. It is however likely that such distortion took the form of the under-pricing of capital used in favoured branches, particularly favoured service branches. Services correspond mostly to non-traded branches whose output is used by all traded branches. In this case, if we ignore historical distortions in the cost of capital, the error introduced into estimates of domestic factor costs is at least of uniform direction across all traded branches.

It is, however, less justifiable to assume that producers exactly cover costs without some refinement to our notion of revenues and costs. In the existing formulae we assume that the branch value added in production exactly covers the cost of domestic factors employed. Implicit in this assumption is the idea that value added estimates the surplus or "disposable income" available to pay domestic factors. But this approach ignores the role of taxes and subsidies in determining disposable income. Commodity taxes reduce disposable income, and direct subsidies increase it.

Let us then define T^F as the $l \times f$ coefficient vector describing net commodity taxes paid by the f branches identified as group F and S^F as the $l \times f$ coefficient vector describing net direct subsidies received by the f branches identified as group F. If we then add the term:

$$(S^T - T^T) + (S^N - T^T)Z^N A^{NT} \tag{10}$$

to the formulae for "$\Sigma F_s v_s$" described in equation (9) we get a $l \times t$ vector describing the actual "disposable income" available to each traded branch. This in turn then corresponds to the domestic factor cost vector "$\Sigma F_s v_s$", given our assumption that disposable income just covers domestic factor costs. This is a more justifiable assumption given that historically, at least in theory, the Hungarian government used the economic parameters at its disposal to leave enterprises with a small positive profit. Dividing the formulae for $\Sigma F_s v_s$ so calculated by the formulae for "$U - M$" described in equations (7) and (8) thus estimates the domestic resource cost vector associated with production in the t traded branches.

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MONETARY POLICY AS REFLECTED BY THE ECONOMIC PROCESSES

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The growing efficiency of monetary policy and management indicate the road covered in the course of transition to market economy. The state of development of market relations can be well measured by the degree of monetization of the economy and by the reaction of economic actors on monetary signals. Monetary policy is aimed, by its very nature, at macro-economic equilibrium targets and thus restricts the autonomy of market actors less than do other elements of economic policy.

The author examines the efficiency of monetary policy and management in the period after introduction of the two-tier banking system, i.e. 1987. The first part of the analysis shows the changes in monetary policy related to economic policy, making palpable the corrective role devolving on it because of the inconsistent targets. The second and third parts evaluate monetary management on the basis of its impact on macroeconomic processes and the behaviour of economic actors. It points out that the positive changes frequently took place not according to the intentions and thus the results achieved are very brittle. Finally the article lists the major factors which hamper the effectiveness of monetary management even today.

The strengthening efficiency of monetary policy and control help to indicate the progress being made towards a market economy. On the one hand, this is because the advance of market relations can be measured quite accurately by the extent of the monetization of the economy and by the reactions given to monetary signs by those participating in the economy. On the other hand, it is because monetary policy is, by nature, oriented towards objectives of the economy's macro-equilibrium; hence, it restrains the autonomy of market participants to a lesser degree than other elements of economic policy.

This paper studies the efficiency of monetary policy and control for that time period which has elapsed since the establishment of the two-tier banking system, i.e. since 1987. The first part of the analysis presents the changes of monetary policy within the relations of economic policy; this will help to illustrate the correcting role it fulfils in connection with inconsistent goals. The second and third parts evaluate monetary control and management on the basis of the effect they exert on economic processes and on the behaviour of the participants in the economy. It points to the fact that positive changes often occur not in conformity with policy intentions, and therefore the results achieved are not durable.

Finally, the study lists the most important factors which still impede the effectiveness of monetary control.*

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The changes of monetary policy

Since 1987 monetary policy—which is rooted in the dominant economic policy, but at the same time acts as its correction—has set itself the basic target of achieving equilibrium.[1]

The endeavour at expansion during the years 1985–1986 (i.e. the last dynamizing attempt of the policy line being followed at that time) led to a significant deterioration of the current balance of payments, and to a drastic growth of the stock of foreign debts. This had the effect of destroying the results of the restrictive monetary policy which had been implemented in 1982–1984 with regard to external stabilization. From the middle of 1987 on, the spectacular failure of the—politically initiated and economically unfounded—enlivening of the economy brought about a turn in economic policy. The time period following it was characterized by *stabilization efforts,* though with varying emphases and priorities in each year. Accordingly, the direct objectives and also the methods applied for the sake of their implementation went through a process of change.

1987–1988: restrictive monetary policy in order to achieve external stabilization

The three-year programme of stabilization accepted in autumn 1987 repeatedly laid stress upon the improvement of the external equilibrium and on stopping the growth of external indebtedness. *In the interest of external stabilization the restriction of domestic demand came to be emphasized;* both the reduction of imports as well as the growth of exports were expected from this. The National Bank of Hungary (NBH) adjusted itself to this demand-restricting economic policy by a restrictive monetary policy: primarily by narrowing the liquidity of the commercial banks. The possibility of this was, however, aggravated by the fact that before the shift to the two-tier banking system, the commercial bank divisions that were to separate from the NBH determined their need for refinancing credits on a level higher than justified. Consequently, the new banks began the year with a liquidity situation that was too great in relation to the deflationary intentions. In addition, a higher than planned abundance of money was caused by the 42 billion forint deficit of the budget, and by the profits of companies and banks which also turned out to be higher than planned.

The central bank was able to drain the surplus money, but only with partial and very rough methods, i.e. by repeated reductions of the so-called "normative

[1] The objectives of monetary policy are contained in the annual financial and credit policies that guide the principles of the *National Bank of Hungary*. They are developed in agreement with the government. The evolvement of the monetary processes is described in monthly and annual reports of the *National Bank of Hungary*.

refinancing credit quotas", which had already been promised. This way of drawing off money resulted in a "one-sided" restriction which made the financing of the current assets of companies that had credit connections more difficult; nevertheless, this still left the lavish spendings of the budget unaffected. By reducing the refinancing of the banks, liquidity crisis simultaneously developed in the bigger banks. This was a situation the central bank was able to cope with, despite the lack of effective monetary instruments—yet this was only due to agreements between the NBH and the commercial banks.[2] The "price" paid for this was the re-appearance of the earlier bargaining mechanisms.

The economic political endeavours of 1988 had *external stabilization* as their main goal, but they were aggravated by *government measures* that first of all liberalized the import and price regulations and then supplied the population with foreign exchange.[3] Monetary policy and regulation were, however, disturbed by several other factors, too. The enactment of the law on taxes entailed a significant rearrangement of income positions. The *inflationary expectations*—interlinked partly with the tax reform and partly with the rising price level of the preceding year—elicited unforeseeable saving and spending behaviour in the spheres of both the households and the companies, as well as in the budgetary institutions. The incalculability of the behaviour of the economic actors and the hesitation of the financial administration (e.g. as regards its conduct towards the demands for support and its endeavours to raise prices) caused hectic behaviour even on the part of those directing monetary policy. The latter tried to delimit the quantity of money in the beginning by raising the rate of reserves and by extending its basis of projection. Later on it rendered the requirements of liquidity more severe; it then increased the interest rates in connection with refinancing and, finally—seeing the low efficiency of all these measures—by narrowing the refinancing credit quotas. (Várhegyi 1989)

However, *owing to the dominance of the budgetary sphere,* the range of action of monetary regulation was rather limited. In the years 1987–1988 the share of the state budget within the stock of domestic credits was 60 percent. In 1988 the restrictive credit policy of the NBH was directed exclusively towards the enterprise sector: while the stock of the credits extended to the banks decreased by 26 billion forints, i.e. 10 percent, the amount of credits granted to state finances grew by 41 billion forints, i.e. by 9 percent.

One effect of the credit-reducing policy of the NBH was that the debts of the enterprise sector also decreased. The restriction of credits had a counter-selective effect: the banks were able to withdraw credits from the companies where sources for this were created. A significant number of companies reacted to the liquidity troubles stemming from the credit restriction by postponing their payment obligations—they did not narrow their actual operations. Hence, credit restric-

[2] For more details see *Várhegyi* (1988).

[3] For more details about this see *Antal et al.* (1989).

tion again enhanced the already reduced inter-company debts and caused serious troubles in money circulation.

1989: liberalization in economic policy—corrections in financial policy

In November 1988 a new prime minister took the helm of government. The *liberalization programme* of the government led by Németh laid the most important pillars of the transition to a market economy. In addition to partial import and price liberalization the constraints based on wage regulation were also relaxed. For the sake of maintaining external stability, beside the liberalization, a restrictive financial policy was needed. Monetary regulation was destined to put a brake on the companies' intentions to raise wages and prices and on their demand for imports. At the same time, owing to the burden of credit restriction imposed on companies in the preceding year, the pressure to relieve credit policy was strengthened by certain loud interest groups (such as the big companies, the economic chamber representing their interests, and even the great banks themselves). Due to this pressure the NBH wished to relieve the restrictions afflicting the companies with a *selective credit policy.*

However, the monetary objectives formulated for 1989 were based on the judgement of the previous year. This was more optimistic than justified and it was based on optimistic predictions about certain factors of the economic processes. The monetary plan reckoned with a deficit in the balance of payments in convertible currencies amounting to between 450 and 500 million dollars, (which in fact finally came to three times that figure, i.e. 1.4 billion dollars) and with a positive balance of 260 million roubles in the non-convertible market (which also trebled, amounting to 866 millions). The monetary plan did not reckon with the effect of liberalizing the supply of the population with foreign currency. This was a measure which had also originated with the preceding government for the betterment of public sentiment, but which also caused the deterioration of the balance of foreign tourism as compared with that of the previous year—it amounted to 400 million dollars in 1989 too. However, the least realistic estimates were with regard to the credit needs of state finances and the sources for meeting these needs. Namely, the monetary plan reckoned with the possibility of covering the greater part of the new credit requirement of the state budget—estimated to be at most HUF 50 billion—from the raised surplus foreign credits and the surplus of the net savings produced by the households; and it was hoped that with these items the missing 10–15 billion loan could be granted to the budget by issuing government securities.

However, after a quarter of a year the *monetary plan was crushed.* It was discovered that the budget of the previous year proved to be correct only in appearance since, for the sake of its "success", the disturbing items were postponed to the following year. Therefore it became necessary to elaborate a rapidly realizable radical action plan in order to reduce the expenditures of the state budget by 30 to 35 billion forints. A successful implementation of this had been one of the pledges connected with the possibilities of realizing the targets of the monetary plan. Yet the central bank could not put a stop to the growing credit demand of the state finances, and thus the fiscal sphere used up almost double the credit possibilities specified in the plan, i.e. 72 billion forints. Given the lack of sufficient domestic savings this credit need could only be covered from foreign credits raised by the central bank.

Finally, monetary restriction comprised merely one component of the domestic credit stock, i.e. the credits of the households: these decreased in real value by 1.4 percent. Owing to this, the domestic credit stock did not reach the level of inflation, and the quantity of money also grew to an extent lesser than both the rate of inflation and the growth of the GDP (see *Table 1*).

Table 1

The development of some monetary indices (percent)

Description	1987	1988	1989	1990	1991	Nov. 1992
Change of domestic credit stock	12.6	5.7	16.2	11.1	7.4	5.6
Change of the stock of money	9.8	3.5	14.0	28.7	28.7	19.9
Rate of inflation	8.6	15.5	17.0	28.9	35.0	21.6
Change of the GDP	12.6	14.9	21.0	21.2	11.3	15.1
Quantity of money as a percentage of the GDP	48.9	44.0	41.5	44.0	50.9	53.0
Kept cash as a percentage of money stock	25.7	26.5	25.5	23.1	22.2	21.7

Source: Annual reports of the National Bank of Hungary

In 1989 the deterioration of the balance of payments came to pass beside a neutral exchange rate policy: the strong devaluations of the forint in the preceding three years were followed in 1989 by a slight revaluation amounting to 1.2 percent. This also contributed to the fact that, despite the liberalization and the greater than planned deficit of the state budget, inflation still did not break loose. The revaluation policy—despite the attacks of those anxious about exports—became in the following years a determinant element of the policy aimed at stopping inflation.

1990: political change—governmental vacuum—monetary policy following the real economy

Though politically 1990 was the year when the system changed, this did not bring about a turn in the economic policy. On the one hand, this was because the previous government, with its common programme of stabilization and liberalization, had already started the policy of transition towards a market economy. On the other hand, the elaboration of the programme of the new (Antall) government was protracted until September and the accepted three-year programme—the "Programme of National Revival"—*was* very soon watered down. Hence, the shifted emphasis formulated in it, (i.e. the economic policy of supply, aimed at economic growth) in this year did not become practice in economic control and management. In 1991, the second Antall government came forward with a new stabilization programme (the "Kupa programme") which was the continuation of the government programme drawn up prior to the change of the system rather than that of the first Antall government.

Among the objectives of monetary policy, in addition to external stability, the checking of inflation also came to the fore. This was due to the high rates of inflation that had emerged in the preceding two years (15.5 and 17 percent, respectively). At the same time, the deterioration in the balance of payments (which had occurred in the preceding year) and the ceasing of foreign trade accounted in roubles, as well as the further import liberalization, rendered it even more important to improve the balance of payments. Of the two objectives of 1990, external stabilization received the greater emphasis. This was reflected on the one hand in the exchange rate policy. This resulted in a slight revaluation of the forint and, on the other hand, in a restriction of the supply of foreign currency to the general public, as well as increasing the customs duties and tax burdens on private imports. The economic political and governmental vacuum which characterized most part of the year 1990, created a favourable situation for the policy in which the NBH was to be strengthened professionally. Beside the "weak state" the *central investments decreased:* the refinancing credit requirement of the State Development Institute fell to half the total of the preceding year. Also, the credit needs of the state finances decreased significantly in real value, and this offered much more scope to the commercial banking sector. The result of this was that the credit stock of the government did not grow, while that of the companies increased by 28 percent.

From the double objectives of monetary policy in 1990 the *improvement of the external equilibrium was successful, but the anti-inflationary endeavours failed.* The central bank was unable to neutralize the surplus demand created by the positive surplus of the current balance of payments. Thus, the company endeavours to raise price levels was successful. Alongside a 1.5 billion dollar betterment of the balance of payments, inflation grew to 29 percent, i.e. a 12 percent increase on the previous year (17 percent). *Monetary policy* in this year *followed rather than influenced the* *real economic processes.* This is shown by the fact that the growth of the amount of money was not lower than that of the nominal GDP, *whereas* in the preceding two years it was 11, and, respectively, 7 percent lower.

1991: Stabilizing government programme—loosening monetary policy

The four-year economic programme of the Antall government—entitled "Stabilization and convertibility"—was completed after ten months of the government's being in office. The programme considered the main task for the first two years—in addition to the fulfilment of external commitments—to be the fight against inflation. However, it also deemed the "treatment" of unemployment to be important, while realizing that because of the changing structure unemployment would be unavoidable.

In 1991 the main objectives of monetary policy were, in addition to maintaining external equilibrium, the putting of a strong brake on inflation, increasing the inclination to save, and furthermore, a supply-activating monetary and credit policy that would stimulate convertible exports, the private sector and small ventures. These objectives in themselves already indicated the *contradictions* inherent in the economic policy. Both the maintenance of external equilibrium, as well as a "selective" revitalizing policy, would have required such monetary solutions which would hardly have aided a "strong" curbing of inflation. A "supply-enlivening" financial and credit policy means, in the first place, a practical a stimulation of demand, which might be followed—if at all, and then with only some delay—by increasing supply. The intention to urge people to save at the same time suggested that there would be a rise in deposits; yet the actual effect was that credit interest rates rose and this again strengthened inflationary expectations.

The development of some macroeconomic indices, despite "built-in" contradictions, approximated to the forecasts, although the partial processes in their background deviated from the plans. So, for instance, behind the planned formation of the consumer price index there was first of all the omission, then the lower degree, and finally the timely postponement of central price rises (e.g. rents or health prescriptions). The 267 million dollar surplus in the current balance of convertible payments and the trebling of the foreign exchange reserves, in a year when the collapse of the former CMEA market required the orientation of Hungarian exporters towards new markets, can indeed be considered a success. The surplus of the balance of payments was due, however, not to a commercial increment, but to the drastic reduction of the foreign currency granted to the population. Due to this reduction an income surplus of foreign tourism came about, amounting to 560 million dollars.

At the same time the surplus of the balance of payments and the inflow of money, by increasing domestic incomes, brought about an unplanned *abundance of money.* The draining of this abundance laid additional tasks on the monetary system. One of the indirect means for this was the 11 percent revaluation of the forint. The—successful—endeavour of the National Bank of Hungary to finance the deficit of the central budget to a higher degree than had been forecast (by issuing state securities and selling them to the banks and not by creating money) may be considered another instrument. Although, with this policy, the central bank was freed from the burden of extending additional credits, by financing the deficit in the market—along with a markedly higher interest rate than that of the central bank—it exerted in itself in such a way as to cause inflationary pressure due to the increase of the deposit interest level and, in the wake of this, due to the raising of the interest on credits.

Table 2

Liquidity factors of the banking system

Description	1988	1989	1990	1991	Nov. 1992
Cash with the banks (KPB) (HUF billion)	18.1	19.4	20.7	26.5	26.6
Banks' deposits with the NBH (HUF billion)	25.3	153.5	293.7	508.4	487.9
of which: obligatory reserve (R)	19.0	33.0	58.3	164.6	193.5
Monetary basis (MB=cash+reserve) (HUF billion)	201.5	232.9	288.8	451.3	506.2
Stock of money (M2) (HUF billion)	620.3	707.2	909.9	1167.3	1348.1
Annual change of obligatory reserve (percent)		73.7	76.7	182.3	17.6
Annual change of monetary basis (percent)		15.6	24.0	56.3	12.2
Change of monetary stock (percent)		14.0	28.7	28.3	15.5
Money multiplicator (M2/MB)	3.08	3.04	3.15	2.59	2.66
Deposits placed with the banks (HUF billion)	449.2	659.6	790.8	1087.6	1309.5
Effective rate of reserve (R/D) (percent)	4.2	5.0	7.4	15.1	14.8
Compulsory reserve and cash in the banks (RC=R+KPB) (percent)	37.1	52.4	79.0	191.1	220.1
Annual change of compulsory reserve and cash (percent)		41.2	50.8	141.9	15.2
Effective rate of reserve in a broader sense (RC/D) (percent)	8.3	7.9	10.0	17.6	16.8

Source: Annual reports of the National Bank of Hungary.
Note: Marks and interconnections on the basis of *Szalkai* (1991).

The inflation target (35 percent) was realized, but this "blundering upon it" can only partly be attributed to a successful monetary policy. Namely, the decrease of the volume of the GDP, instead of the 3–4 percent taken into account in the monetary plan, came to be 11 percent. In other words the realization of the monetary plan came about *alongside a narrowing down of the real economy to a extent greater than was expected.* Undoubtedly, the monetary policy of the NBH was rendered more difficult by the external position of equilibrium, which was more favourable than expected, by a measure of 2 billion dollars. The outflowing surplus money appeared first of all in a strong growth of the population's savings: *the net savings of the population doubled.* In this an important role was played by the fact that the effect of the retroactive raising of the favourable interests of the earlier received housing credits and the 82 billion forint budgetary subsidy (which was in order to urge the accelerated amortization of these credits) was to be a reduction of the debts of the population by a total of 124 billion forints. In addition to other factors (i.e. the declining demand for credits because of the rising real interest rates, and the inflow of foreign capital), this also contributed to the liquidity of the banks. In order to neutralize this, the NBH broadened the projection basis of the rate of compulsory reserves requirement, whereby it practically doubled the effective reserve rate (see *Table* 2). The increase of the bank reserves exceeded 100 billion forints. Furthermore, the much lower increase of refinancing granted by the central bank led to a situation in which *the banks became net depositors with the NBH.* In addition to increasing the severity of the reserve policy, another method of draining the surplus liquidity of the banks was the selling of treasury bills to the banks. Both methods of liquidity reduction simultaneously served the financing of a higher than planned deficit of the state budget.

1992: the anti-inflationary objective comes to the fore

The 35 percent "record" inflation in 1991 which, in addition, came about beside an 11 percent recession of the economy, made it necessary to make the anti-inflationary objective a main priority within the system of monetary objectives. Though this coincided with the economic political priority of the official government programme, the intentions of economic revitalization formulated by the various government and political forces offered no favourable scope for continuing the anti-inflationary policy.[4]

The greatest challenge for monetary policy was the huge deficit of the state finances. This was not only 73 percent higher than that of the previous year but amounted to almost triple the figure regarded as acceptable by the parliament; also, it reached 7.5 percent of the GDP. A significant cause of this record deficit was the declining tax revenues, the latter brought about by economic recession and the changing regulations. The income-restraining influence of the constraint of changing the markets was strengthened by the enactment of the law of bankruptcy.

[4] For more details about this see Várhegyi (1992).

The timing of this enactment helped to concentrate masses of liquidations primarily in such organizations that could not easily evade the control of the tax authorities. As a result of this the profit tax paid in by the companies amounted to only 64 billion forints, instead of the planned 85 billion. The possibility of forming reserves to cover risk offered to the banks in the law on the financial institutions reduced the earlier tax and dividend payments of the banks from 63 to 1.7 billion forints.

The enormous deficit of the state budget left its mark on the monetary policy of 1992. Though the NBH was no longer obliged to finance the whole of the deficit, it retained the task of having to reduce the liquidity in order to counterbalance the overspending of the state and to sell the state securities. The receipts arising from the latter covered the largest part of the deficit. In the course of the year the stock of state securities rose to 300 billion forints. Another tool used to narrow the liquidity was the raising of the compulsory reserve rate from 15 to 16 percent.

Narrowing the liquidity, however, rendered it more difficult for the NBH to reduce the interest rates for the purpose of breaking down the inflationary expectations and inflation itself. Though in the course of the year it repeatedly reduced the interest on the refinancing, revitalization of the credit demand was still not implemented. On the one hand this was because, owing to the growing bank risks, the real interest rates attached to the entrepreneurial credits remained high, despite the significant reduction of the nominal interest levels (see *Fig. 1*). On the other hand, in the money market the outward pressure of the state securities played an ever increasing part.

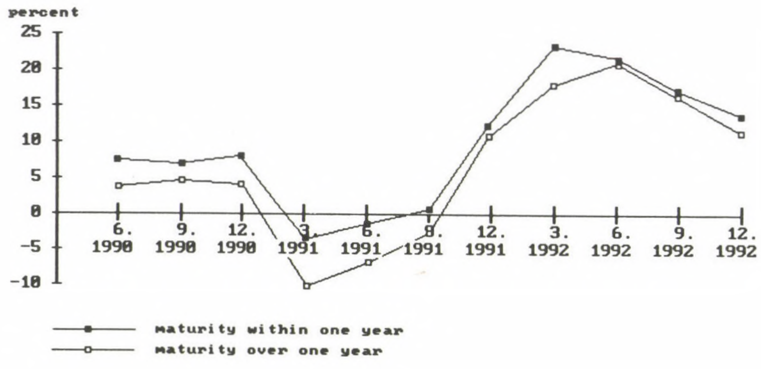

Fig. 1 Real interest rates attached to entrepreneurial credits

Parallel with the preceding measures, the interest rates for both the freely decided and the obligatory deposits with the NBH, decreased. This meant a liquidity and income narrowing effect in the banking sector, due to the increasing volume of obligatory reserves. However, the radical reduction of interest paid on the obligatory reserves (which took place in several steps, from 11 to 2 percent) partially counteracted the intentions geared towards revitalizing the economy, since it contributed to maintaining the high interest margins of the banks.

The anti-inflationary policy of 1992 finally became successful: the annual inflation rate fell from 35 to 23 percent. At the same time it must not be forgotten that the fall of the rate of inflation came about beside a powerful augmentation of liquidity in the economy. In the background of the 31 percent nominal growth of the quantity of money there was a 40 percent increase of the population's savings. This free liquidity is hovering above the economy as a monetary "overhang" and may easily precipitate an open inflation.

The success of monetary policy as reflected in macroeconomic processes

It is the usual practice to judge the success of monetary policy and regulation in accordance with the fulfilment of the economic political targets and of the major macroeconomic indices. Under the conditions of an advanced economy this is indeed enough. In a changing economy, however, the important yardstick of success of economic control and management is whether the participants of the economy are able to transform their behaviour and be responsive to monetary signals.

External stability

Since, in the whole of the analysed period, it has been an emphasized economic objective to create and/or maintain foreign economic stability, the development of the balance of payments, of foreign exchange reserves and of the stock of debts are important measures, indicating the success of the economy and monetary policy.

The 700 million dollar reduction of the deficit of the current convertible balance of payments in 1987–1988 was again followed, owing to the liberalization measures, by another strong increase in 1989. The decisive role in the deterioration of the balance of payments was played by the increased volume of foreign currency granted to the population, which in 1988 and 1989 caused an additional expenditure of about 1 billion dollars. Apart from the results of this abortive decision, which was based on political motives, the performance of foreign trade was advantageous: the balance of trade showed a significant positive surplus, owing to the dynamic growth of exports. 1990 was the first time since 1984 that the balance of payments showed a positive result (of 127 million dollars). Following this, the value of the surplus was growing unabatedly: in 1991 it amounted to 267 million dollars and in 1992 to 324 million dollars (see *Table 3*).

Table 3

Development of the foreign economic position
(convertible accounts, million dollars)

Description	1987	1988	1989	1990	1991	1992
Exports	5,050	5,505	6,446	6,346	9,258	10,028
Imports	5,014	5,016	5,909	5,998	9,069	10,076
Balance of trade	36	489	537	348	189	−48
Balance of foreign tourism	368	41	−349	345	560	660
Current balance of payments	−876	−807	−1,437	127	267	324
Direct foreign investments	0	14	187	311	1,459	1,471
Reserves	2,159	1,976	1,725	1,166	4,017	4,380
Gross amount of debts	19,584	19,603	20,390	21,270	22,658	21,437
Net amount of debts	13,683	13,697	15,938	14,900	14,554	13,000
Debt service as a proportion of exports of goods and services	55.3	46.7	38.5	45.5	31.5	30.9

Source: Annual reports of the National Bank of Hungary.

Though since 1987 the gross amount of debts has somewhat increased, its composition with regard to maturity has improved: the share of the medium- and long-term debts rose from 82 to 90 percent. The debt services measured as a proportion of the exports of goods and services significantly decreased between 1986 and 1989 (from 75 to 38 percent). Afterwards, following a transitory period of growth, it continued to decrease. (The reduction in 1991 was in some regards absolute: it was a consequence of the termination of rouble accounting.) After four years of decline and the dangerously low level in 1990—amounting to the value of a mere two months' imports—in 1991–1992 the *reserves of foreign exchange* quickly increased and reached the value of half a year's imports. In this process, besides the improvement of the balance of payments, direct foreign capital investments also played a part. Thus, it may be said that, *with regard to the whole period, the objectives of external stabilization were achieved.* It deserves mention that the improvement of the foreign economic position took place parallel with the liberalization of the imports and the relief of constraints on the management of foreign exchange. This draws attention to the fact that in recent years the Hungarian economy has operated on the basis of mechanisms other than those it used in the early eighties. At that earlier period the foreign economic position grew better primarily because of the effect of severe import restrictions and only secondarily because of strict monetary policy. In the early 1990s monetary signals in themselves were already able to influence the real economy, even if sometimes and at certain places interventions of an administrative character became necessary (e.g. for maintaining the foreign exchange quotas of the population).

It has to be emphasized that the improvement of the foreign economic position illustrates the difficulty of maintaining the budget deficit, for instability of the domestic economy obviously endangers external stability too. It is also remarkable that in 1990–1992 the external position did not worsen even beside an effective real revaluation of the forint.[5] The exchange rate policy brought about successful manoeuvres between the anti-inflationary and foreign trade objectives: while it restrained the breaking loose of inflation, it did not prevent foreign trade and tourism bringing about a significant positive balance.

Inflation

The greatest failure of the economic policy that put emphasis on the goals of equilibrium in foreign trade was the loss of control over inflation. Still, it cannot be claimed that an unequivocal trade-off mechanism developed between the foreign trade position and inflation.

The interconnections between the numerically quantifiable factors varied over the different years. Since a deficit in the balance of payments—and especially a deterioration in the situation—implies the drawing of some income out of the country, this in itself ought to show a deflationary effect. In turn, the budget deficit and growth of the deficit have an inflationary effect, if financing the deficit can only be solved by creating money. Yet, while in 1988 the current balance of payments showed a deficit only slightly less than it was in the preceding year, the rate of inflation grew to a significant degree: from 8.6 to 15.5 percent. At the same time the budget was almost in equilibrium. Simultaneously, in 1989, beside a significant deterioration of the balance of payments, inflation continued to grow, though it is true that in the meantime the budgetary deficit doubled.

The trade-off effect between the balance of payments and inflation can be clearly observed in 1990: the significant improvement of the foreign trade position (by 1.5 billion dollars) was actually accompanied by a powerful growth of inflation (from 17 to 28.9 percent), while in effect the state budget was balanced. However, in 1991 it may be presumed that it was the budgetary deficit,—which grew to a huge degree—that was the main source of the further increase in inflation. (It has to be noted that the state no longer received unlimited credits from the central bank, so it had to take measures in the money market too. Here, however, it exerted adverse effects on interest rates and, via those, on the inflationary expectations.) The liquidity of the economy was also increased by the inflow of 1.4 billion dollars of venture capital. In this year, the inflationary effect was at the same time mitigated by the appearance of open unemployment.

[5] See *Hungarian-International Blue Ribbon Committee* (1992).

1992 brought about another change: for the first time for several years inflation was eased. However, besides the continued improvement of the balance of payments there was a persistent and strong growth of the budgetary deficit; it is also true that these achievements were at the price of a significant growth of unemployment and regression of the economy. In the moderation of inflation the following processes were very evident:

— *recession of the economy;* owing to the declining GDP the total domestic demand also decreased;

— *the ratio of savings* was high, amounting to 11 percent; due to this the demand in the consumer market diminished to a higher degree than was justified by the decreasing income;

— *the real policy* of revaluation rendered imports cheaper and also checked the rise of the domestic price level through import competition;

— *the new law on accounting* prohibited booking the doubtful debts as returns. Hence, the inflation-causing "false incomes" were not realised and thus were eliminated from the balances. Earlier, premiums, wage rises and tax payments, generated real (spendable) incomes (which monetary regulation was only just able to counterbalance) by subsequently drawing off money. However, this caused strong inflationary expectations in the economy;

— *the law on bankruptcy;* the liquidation procedures had the effect of creating an oversupply in the market of means of production and real estates and exerted a price moderating effect.

The factors listed above reflect the fragility of the processes used to put a brake on inflation. Given the nature of the 1993 budget law and the endeavours of the government to revitalize, it is probable that the coincidence of the positive factors will not occur again, while the inflationary effects will continue to exist. The most important means of moderating inflation would be if the deficit could be financed *from the increase of domestic savings.* However, this would be difficult with a budget deficit planned to be HUF 185 billion (and which according to other forecasts will exceed that figure) and the deficit of social insurance to be around HUF 40 billion (yet likely to attain estimated double this total).

The government programme for 1993, however, reckons with a nominal reduction of household savings. The propensity to save is likely to decrease due to falling interest rates, which will be less than that of the inflation. This will result in a (negative) real interest rate which will be even lower than in the preceding two years. Since most of the deposits are tied up for short terms, the danger of the drastic decline of savings is really great. If these flow not to the investment market but to the consumers, the interest-moderating policy will lead not to revitalization the economy but to accelerating inflation.

The fact that the economic political plan for 1993 reckons with a 10 percent growth of the value of investments and 1.4 percent increase of the GDP reflects the optimism of the government rather than the real processes. For the sake of initiating growth the government plans more significant subsidies than those granted so far (in the form of cancelling debts, company reorganizations) and general concessions (e.g. softening the law on bankruptcy). Owing to the overburdened budget, the government is looking to the revenues coming from privatization (to be realized in the future) in order to finance these revival measures. If, on the other hand, the government spends the incomes it receives from selling productive property on items which do not reduce the state debts, the means of covering the debts may run out. This process would soon lead to further growth of the current budgetary deficit and finally to the acceleration of inflation and/or to the deterioration of the external position.

Savings and the monetization of the economy

A significant moment at the end of the eighties and beginning of the nineties was *the rocketing growth of the financial savings made by the population.* If the inclination to save is characterized by any one of the appropriate indices, the fact of the change is obvious (see *Table 4*). Strangely, the population's readiness to save increased at a time when the—statistically recorded—real incomes declined. In the growth of the financial savings of the population the improvement of the banking system and the competition for resources played a significant part. The *strengthening competition* adjusted the interest rates of deposits and bank securities more and more to the rate of inflation. Thus the loss in value of the savings tied up for a year lessened in 1991–1992. (However, owing to the 20 percent tax on interest incomes, the net interest rates even then did not reach the rate of inflation.)

Table 4

Savings of the population

Description	1984	1987	1988	1989	1990	1991	1992	1993
Savings as a percentage of available income	7.24	5.28	5.29	3.98	9.37	15.45	13.73	11.42
Financial savings as a percentage of available income	1.9	−0.2	1.3	0.4	9.2	17.1	11.8	9.7
Savings as a percentage of the GDP	4.92	3.47	3.55	2.64	6.41	12.22	10.86	8.73
Financial savings as a percentage of the GDP	1.3	−0.2	0.8	0.3	6.3	13.5	9.4	7.4

Source: OECD and Ministry of Finance

The improvement of the equilibrium of the consumer market exerted a favourable effect on the increase of the population's inclination to save. This was due to the disappearance of the earlier shortage of commodities, import liberalization and the increasing liquidity constraint on the companies. Another effect was brought about by the cessation of state patronage, or at least by the declaration to make efforts to achieve this aim. *Growing social uncertainty,* and furthermore, the cuts in subsidies to housing, revalued the existential significance of savings. The current growth of financial savings and especially of the stock of net savings were influenced by the regression of housing investments.

In the 1990s the *savings* not only of the households but also of *the companies* increased to a significant extent. Between 1989 and 1992 the total deposits of the companies increased by 22 percent in real value; this was due partly to the strengthening liquidity constraint and partly to the benefit of laying out money which was higher than that of capital investments.

The strengthening inclination to save has increased the *monetization of the economy:* the ratio of the stock of money in relation to the GDP increased by 7 and 3 percent in 1991 and 1992, respectively. Simultaneously the ratio of the stock of money kept in cash decreased from 25.5 to 22 percent. These processes indicate in parallel the economy's money demand for transactions, the strengthening liquidity constraint on the companies and the growing confidence of the population in money itself. All these three factors are concomitants and conditions of building up a market economy.

Economic growth and capital investments

The external stabilization of the Hungarian economy, which on the whole has been a successful process, was carried out beside a decline in the size of the economy and a decrease in the volume of the GDP. Although the slowing down of the economy was never a formulated and explicit economic political target, the limitation of domestic consumption and accumulation was a direct consequence of the objectives of external equilibrium. In addition to the demand-restricting policy which accompanied the anti-inflationary and external stabilization endeavours, the collapse of the Eastern markets in the 1990s contributed to the decline of the GDP. While between 1986 and 1988 the economy showed a growth of altogether 4 percent, between 1988 and 1992 an 18 percent real decrease was registered. (Realistic evaluation of the figures is made difficult by the confusion of the statistical system, this itself being due to the growing distance between the recorded data and the actual processes.)[6]

[6] Statistical recording included only organizations employing more than 50 persons, whereas along with the transformation of the economy the number of organizations smaller than the above

Since the lessening of the GDP occurred not only because of the external stabilization but much more because of the narrowing Hungarian and Eastern markets, the situation may be judged by asking whether the changes which have taken place really have improved the market adaptation and income-creating potential of the Hungarian economy. Though signs of the latter cannot be seen yet,[7] the changes in the behaviour of the participants in the economy—to be discussed later on—show some growth of the faculty of adaptation to the market.

The powerful setback experienced by capital investments points to the fact that the Hungarian economy is only in the primary, more painful stage of restructuring: cutting down the non-marketable capacities has already started but the creation of new ones is still lagging behind. Since 1988 the proportion of investments to the GDP has declined continuously: from 24 percent in 1987 it has fallen to 18 percent. The real value of investments has, within five years, diminished by 20 percent.

The lack of investments—in contrast to the processes of earlier decades—was not the result of the administrative control of financial management,[8] but primarily a reaction to changes in the market. The companies responded to the narrowing of the market and worsening profitability primarily by reducing stocks and investments and only resorted to manpower reductions as a last resort. The motives of short-term survival, parallel with the slackening of state patronage, led to a decline of the intentions to make investments. This can also be traced back to the decline of the demand for investment credits: the total investment loans granted to enterprises up to the end of 1992 did not even nominally exceed that of 1990, whereas the liquidity of the banks was greater in 1991–1992. Also, the interest level of the investment credits was, for the whole period, lower than that of the short-term loans (the difference moved between about 1 to 6 percent). With the moderation of demand for investment credits, the real credit interests had a

is increasing. On the other hand, owing to the disinclination to pay taxes, even the reported activities do not always reflect the truth. Several "innovative" methods were developed for reducing tax obligations by classifying actual economic activities in the wrong—and consequently tax-reducing—categories (e.g. investments instead of consumption or current costs instead of investments etc.).

[7]The situation today shows a serious crisis in certain sectors. Significant numbers of participants in the economy (e.g. engineering industry or agriculture) were only able to increase their exports at the cost of declining profitability. What is more, they made losses, and this has led to a drastic reduction in certain companies' property. The sales crisis of agriculture has been aggravated by the destruction of the earlier developed production units (i.e. the farming cooperatives) owing to the politically initiated laws on compensation involving the return or redistribution of land.

[8]A key element in the financial control of the sixties and seventies was "keeping a firm grip" on company investments. In practice this meant an administrative restriction on the development of company investment sources, the collection of development funds deemed to be superfluous, the application of taxes that made investments artificially more expensive, and the imposition of severe central control on crediting activities of banks.

decisive role; the latter were far beyond the profit prospects and the strengthening liquidity constraint.

Unemployment

The drastic increase of unemployment in the nineties can be considered the "price" of economic transformation and external stabilization. While in the 1980s registered unemployment was below 1 percent, in 1991 it increased to 7.5 percent and by the end of 1992 it had reached 12.2 percent. In 1993 the growth has continued owing to company bankruptcies and liquidations.

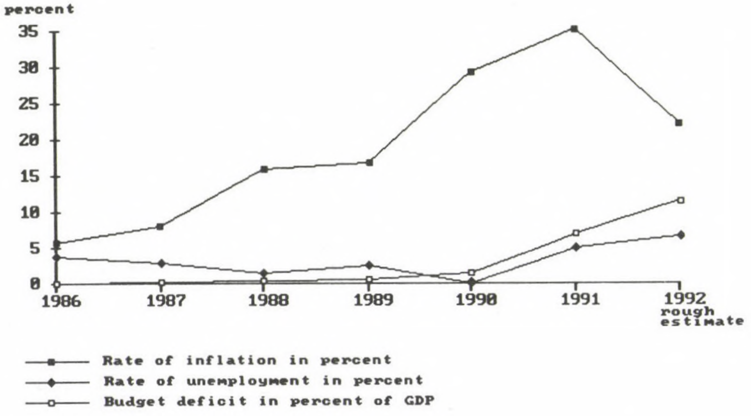

Fig. 2 Inflation, unemployment and budget deficit

Analysing the problem of the trade-off between inflation and unemployment (see *Fig. 2*) it can be claimed that growing unemployment contributed to a decrease in inflation in 1992. The fact of the trade-off is, however, not unequivocal. On the one hand, it is of course true that with the granting of state aid to the insolvent companies some jobs would have been saved. On the other hand, it is also a fact that the reduction of subsidies to production and exports amounted altogether to only 2 billion forints, while the decrease of company and bank payments was 49 billion forints. The fact that the economy collapsed in 1992 was largely independent of the policy of government supports; rather it was a result of the narrowing sphere of the markets. In addition, the "melting" of company profits was the consequence of not only the decreasing sales returns and the rising production costs, but also the cessation of fictive profits (the latter were due to the former loose accounting regulations).

The crushing of the traditional markets and the building of market economic norms into the conditions of regulation exerted such a shocking effect on the majority of companies that the short-term result could not be anything other than the loss of some jobs. This could not be avoided even with a more expansive monetary policy. Beside a budget deficit amounting to 7.5 percent of the GDP and the abundant liquidity of the economy a greater expansion could not even be considered as a realistic alternative. The significant decrease of inflation that came about despite the growing volume of money shows that *the conditions of investments serving to create jobs were missing in the economy.*

Changes in the financial behaviour of the participants in the economy

The growing power of factors regarding liquidity, risks and yield in the decisions of companies

The effectiveness of monetary policy—beside the too large and powerful financing demand of the budget—was, for a long time, retarded by inter-company debts, and, in the wake of these, by the enhancement of the *forced commercial credits*. From the aspect of monetary regulation, the basic difference between the two phenomena is that the requirement of financing the budget openly appeared and thus its monetary effect could be planned and—by applying proper instruments—compensated. However, the amount and effects of the forced inter-company credits was incalculable. Namely, the "recipient" of the credit did not appear openly on the credit market, and simply failed to pay the outstanding debt to the supplier. The "credit supply" of the company that was forced to extend a credit to the non-paying buyer did not appear openly on the money market. The monetary authority obtained information only subsequently and by means of indirect notices: the commercial banks that were keeping the accounts gave reports about the uncovered money orders that had been placed with them.

The unfortunate spread of the phenomenon (called in the slang of professional Hungarian economists "queueing"—on the basis of the wording used in the former planned economy) at the end of the 1980s retarded monetary planning and regulation and exercised basically disadvantageous effects on the attitudes of the companies towards their payment usages and liquidity management.[9] If the lack of liquidity could be resolved "painlessly", without being creditworthy and by postponing the payments, then there would be no real constraint on the economy for the sake of changing the system of management.

[9] For literature on this subject see e.g. *László* (1991), *Sánta* (1991), Várhegyi (1991).

Notwithstanding this, before the coming into force of the laws on bankruptcy and accounting, most of the companies were ready to take to notice of the non-payment of their customers, if they themselves could shift it over to their own supplier. Since the bad debt was not a charge on the balance sheet, (there was no obligation to form a reserve), the non-realized return at the same time enhanced the income recorded on the balance sheet. Thus the company leaders interested in the profit shown on the balance sheet, suffered no harm. In turn, the shortage of credits created by the restrictive monetary policy, could be partly compensated by this specific "means of payment", brought about by the "chain" of "circular debts".

Although, from the mid-eighties on, the possibility of liquidating companies appeared as an option for those controlling and managing the economy, in 1992 only the law on bankruptcy came into force and this had a material effect on the companies' behaviour. While the former rules rendered the question of aiding or liquidating the companies a subject of bargaining among the state organs, companies and banks, the law on bankruptcy made the survival of the debtor conditional upon a business agreement between debtor and creditor. The law—despite several problems that are not detailed here—contributed to the improvement of the financial discipline of the companies and the predominance of liquidity management, customary in the economic operations of companies working in the framework of a market economy. One sign of this can be seen in the fact that in the course of 1992—according to the estimate of the NBH—the extent of "queuing" decreased by 60 percent. Several details also prove that the significance of financial planning and of the scheduling of incomes and expenditures came to be highly appreciated.[10]

However unfavourable a phenomenon the decline of investments was, there were also some factors in it that indicated that the positive changes of behaviour were effective. Namely, this could be seen in such things as the *increasing role of yields and risks* in company decisions on investments. While in the former decades it was characteristic for companies to fight for investment sources, in the 1990s the hunger for current money precedes the hunger for investments. This is reflected in the fact that the interest level of the short-term credits over the most recent period has regularly exceeded the average interest level of loans for a period of over one year. Between 1989–1992 net indebtedness of companies to the banks decreased in real value. Behind this there was an increase of deposits that was more rapid than that of the credits. The increasing liquidity of the enterprise sector (which is marked by the fact that its stock of deposits in real value has trebled over the last three years) stimulated not the augmentation of risky investments but the stimulation of savings producing more attractive benefits and having lower risks. In these decisions, alongside the likely yields and risks, in all probability the strengthening constraint of liquidity also played a part.

[10]This observation can be credited to *Gy. Rózsahegyi*.

The strengthening role of the chain of "liquidity—yield—risks" in company decisions can be regarded as a positive symptom even if, in the short run, it contributes to the recession of the real economy and to the growth of unemployment. However, it is an unfortunate fact that, owing to its high indebtedness and ineffective operation, the financial administration has a higher demand for financial resources and consumes greater revenues than the state administration of a prosperous country. Consequently, the tax burdens imposed on the companies and the real interest rates attached to company credits are higher than would normally be expected; at the same time the state is unable to fulfil its necessary role in bearing the costs of economic restructuring.

Nevertheless, it has to be recorded to the credit of monetary control that it did not traverse the effects of laws contributing to the application of market norms (law on bankruptcy, on accounting etc.) by loosening its monetary policy. In other words it tried, using its own means, to check the inflationary trends. One of the tools chosen for this purpose—i.e. the real revaluation policy—interfered with the interests of exporting companies although it did not damage the position of external equilibrium). However, it reduced the likelihood that the burdens of transformation should fall, by the way of inflation, on the most defenceless strata of the population.

Changes in households' behaviour

Some changes can also be observed to have occurred over the past three years in the financial attitudes of the households. A remarkable symptom of change is a shift in the ways in which available income is used, especially the positive tendency towards financial savings. The fact that this came about in a period of decreasing real incomes shows the consciousness of the change. *The strengthening confidence in money* equally reflects the success of monetary policy, the end of the shortages of goods, but also the worsening of social security.

The supply market which came into being as a result of import liberalization and the liquidity constraint on Hungarian enterprises, promoted the development of a more rational form of consumer behaviour: it reduced the former tendencies to reserve commodities and accumulate real goods. This effect was strengthened by the modernization of the banking system, i.e. the multiplied forms of savings. Also, due to competition between the banks, the standards of bank services were also improved. On the other hand, the deterioration of social security (i.e. the appearance and growth of unemployment, the declining level of social insurance services, furthermore the realization that it was necessary to give up the concept of the "patronizing state") all increased the constraints on families to take charge of their own financial affairs.

The influence of monetary policy on the inclination to save is not so clear. In principle the rapid growth of inflation (and inflationary expectations) might have stimulated consumption at the expense of savings. In fact this did not happen, so the successful incentive to save was also instrumental. Freeing the top rate of interest acted in this direction and contributed to the circumstance that it was precisely at the time of the highest inflation, in 1990–91, that the rate of savings jumped high. (While in the 1980s this rate moved between -0.2 and 1.9 percent, in 1990 it was 9.2 percent and in 1991 it reached 17.1 percent.) The development of positive real interests in the wake of the competition between banks to obtain resources, (in which the withdrawal of refinancing by the issue bank also played a part) encouraged the population to save money. The forint savings were also advantageously influenced by the real revaluation appearing in the exchange rate policy which—together with the effects of interest rates and foreign exchange liberalization—resulted in the ending of advantages associated with the keeping of foreign exchange.

In the financial decisions of households the *ability to react to monetary signs* grew stronger. Albeit with some delay, the population generally responded to changes in the market interest and exchange rates. Although it is difficult to prove the nature of this saving in an exact way, justification of this statement can be supported by some examples. The population's increased awareness of the role of interest rates is best indicated by the shift in the structure of savings. On the one hand the proportion of household saving kept in cash and bearing no interest diminished between 1989 and 1992 from 33 to 25 percent. On the other hand, the ratio of *savings in securities* grew from 10 to 24 percent, partly even to the detriment of deposits. This shift of proportions was due to the interest rates of bank and state securities, which were higher than those of the deposits tied up for similar periods. (In 1991 the net interest of bank securities payable on sight was higher—on average by 2.6 percentage points—than that of deposits with the National Savings Bank. In the case of deposits tied up for one year the difference was 2.1 points, while the net interest of a one-year interest-bearing bond was 3.5 points higher than that of a Savings Bank deposit tied up for a year.)

One example of a delayed response to the changed interest proportions is presented by the development of *foreign exchange deposits*. Between 1989–1991 the ratio of foreign exchange within savings rose from 5 to 16.9 percent but afterwards, in 1992 it sank to 13.5 percent. At the same time, because of the real revaluation of the forint and the competition of the Hungarian banks for sources that could be gained from the population, already in 1990 higher interests could be reached on forint savings than on foreign exchange deposits. However, the population responded to the increasingly obvious difference of yields with the relatively short delay of one or two years: the decrease in the ratio of foreign exchange deposits came about only in 1992.

The delay of the response of the population to monetary indications was primarily caused by the strong influence of *expectations* exerted on company decisions. This can be explained partly by the uncertain prospects of the economy and partly by the population's great distrust of the government. The basis of the former can be found in the fact that the outlooks for markets became doubtful due to an unprecedented situation caused by the crisis and transformation of the Hungarian and other East European economies. The latter may be perceived as a result of the state of affairs that developed over four decades and which was built upon mutual mistrust between state power and inhabitants.

The factors influencing the efficiency of monetary control and management

Since the introduction of the two-tier banking system monetary control has developed considerably. The greater autonomy of the central bank, the modernization of the range of monetary tools, the relief of the segmentation in the capital market, the growing intensity of competition among banks, and the application of the norms of a market economy in the regulation of companies and banks all helped to increase the *efficiency of monetary control*. Thus the fulfilment of the monetary goals came about beside a monetary regulation that was growing finer, and thus the application of administrative instruments became less necessary.

The improvement of the efficiency of monetary control was the result of not only the modernization taking place in the banking system but the changes of economic policy. The latter intensified the liquidity pressure on the participants of the economy and hence increased their responsiveness to monetary impulses, thus making a significant contribution to this effect. This change of behaviour rendered it possible for the central bank to influence the liquidity of the economy increasingly by means of the interest rates, the exchange rates and operations of the open market. Another factor acting to this end included the refinancing credit quotas that directly influenced the money supply. These were pushed into the background and—by the end of the analysed period—the rude jerks defining the compulsory reserve rates had abated. Continued strengthening of the effectiveness of the fine regulation of monetary control has been made probable by the more favourable circumstances that had developed by the end of this period; the following may be considered as representing some of these:

— the economy has been monetized to a higher degree owing to the growing ratio of financial savings; furthermore, there has been a decrease in the involuntary inter-company crediting that was beyond the reach of the monetary sphere's operation.

In addition to the changes in a positive direction some adverse phenomena have also remained and these have *slowed down, postponed, or distorted the effects of* *monetary regulation.* The most important factors hampering the effects of monetary policy are the following:

— occupation of the monetary market by state finances for the sake of financing the considerable deficit;

— inconsistent goals and uncertainty of the economic policy; and

— great lack of trust in the processes of economic control and management on behalf of the participants of the economy.

The excessively large economic role of the state exerts unfavourable effects in varied ways. From the aspects of monetary policy and regulation, however, the most important negative point is the outward pressure exerted on money and capital markets and the influence of the state in its role as the owner of the big banks and the dominant proprietor of their most important clients. The former circumstance resulted in a situation in which the relations of the money markets and the capital markets were determined by the budgetary policy rather than by the system of monetary goals. The role of monetary regulation was, on the one hand, to finance the budgetary deficit and, on the other hand, to counterbalance its inflationary effects. Therefore, despite the formal autonomy of the monetary authority, no scope was needed for effective regulation to develop. The role the state played in the sphere of the big banks and the circles of their clients and as the dominant owner of the state-owned enterprises, distorted the conduct of the mediating system of monetary institutions. The survival of the proprietory interpenetration implemented through the state conserved the mutual dependence which is primarily responsible for the present distortion of capital allocation and the bad credit portfolio of the banks.

The uncertainty of economic policy in recent years has, on the one hand, been evident in the inconsistency of monetary goals and, on the other hand and connected with this, in the parallel application of regulatory elements that act against each other. The former originated from the indecision caused by the dilemmas of "growth *versus* stability" and "external stability *versus* internal stability". The really existing economic dilemmas caused greater than necessary uncertainty, owing to the power struggles among the different branches of government. This helped to increase the uncertainty in the external an internal processes of the economy. The economic political intentions were often modified and thus difficult to calculate. From time to time this elicited hectic monetary regulations (e.g. the uneven rate of reserves) and contradictory measures (e.g. the measures for reducing interest rates and restricting liquidity) from the central bank. The indecisive nature of economic policy and the uncertainty of economic processes were strengthened by the problems associated with the resetting of monetary tools.

The lack of trust evident among the participants of the economy is rooted in the past and is the result partly of the uncertain and therefore uncountable nature of economic policy and control. The use of colourful rhetoric instead of effective measures or, sometimes, the explicit contradiction of those measures, (e.g.

venture-friendly slogans *versus* tax rises) compounds the survival of speculative and elicit reactions. These retard the efficiency of regulation. Mistrust, however, has evinced itself not only against the leaders of the economy but towards the actual economic processes, too. (For instance, despite the period of declining inflation, the inflationary expectations did not diminish.)

The adverse processes mentioned above are very probably necessary concomitants of the transformation to a market economy. However, their lasting survival may counterbalance the positive effects of the market behaviour that is developing across a broadening sphere of those participating in the economy. As a result of this a monetary regulation that harmonizes and influences market impulses for the sake of macroeconomic equilibrium may easily miss the mark. For this reason it is necessary to nullify those artificial dependencies and market distorting relations which deflect the market signals in a direction which deviates from one that leads to objectives of macroeconomic equilibrium. An important condition of this should be the reduction of the direct economic role of the state by means of privatization of the banks and enterprises and a decrease of the budget deficit.

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FINANCIAL SOURCES OF ENTERPRISES IN 1992-93

ZS. MOSOLYGÓ

Hungarian economy is on a path of a dampening downward spiral. There is still no solution to the financial crisis of the corporate sector. This has an adverse effect on the provision of firms with financial resources. The bad economic-financial situation of firms has spread to the financial sector too. Crediting by the banking sector decreased in real value substantially in 1992. Interest on loans is very high, interest margin has increased. This forced better performing firms to turn directly to foreign credit markets. The market of securities was characterized by the hegemony of government bonds. There are few Hungarian firms ripe for introduction to the stock exchange. By issuing bonds firms get cheaper capital than by relying on bank loans. For ventures an additional source of financing is leasing, whereas in the service sector foundations are the source.

In 1993 it is expected that the general situation of the Hungarian economy will be characterized by a continuation of recent trends. The economy is experiencing a negative spiral which appears unstoppable but is in fact decreasing in its dynamism. The unsettled financial situation, confused ownership of the corporate sector, and (as a partial consequence of these factors) insufficient foreign and domestic demand, contribute to the economic recession. No solution has been found for the financial crisis of the corporate sector, although the need for such a solution is a decisive factor for obtaining external sources for companies. Bankruptcy procedures are not clear, few bankruptcy cases have been closed satisfactorily and

Table 1

Balance sheet of the central budget of 1993 (fragments)
Hungarian Forints (HUF) 1 million

REVENUES	1991 facts	1992 forecast	1992 probable	1993 forecast
Contributions of business organizations				
Corporation tax (without banks)	77,338	85,000	49,000	54,000
Special contributions	32,346	26,000	25,000	25,000
Customs and import duties	61,622	66,500	75,500	82,000
Contributions on state property	18,446	20,000	6,000	6,600
Gambling tax	472	6,500	4,300	5,500
Other contributions	10,143	11,800	11,800	15,600
Total	200,367	215,800	171,600	188,700

Source: The budget of the Hungarian Republic in 1993.

Akadémiai Kiadó, Budapest

arrangements often serve only the postponement of the problems. Liquidations and illusory arrangements outnumber the programmes providing genuine recovery, of which there are few. It is expected that the number of corporate bankruptcies and liquidations will remain high in 1993.

The dramatic worsening of the financial position of state-owned enterprises and private companies (hereinafter: companies) is shown by the significant slump in the nominal value (and, an even more significant indicator, slump in the real value) of the company contributions to the budget (see *Table 1*) and by the increasing number of bankruptcy procedures and liquidations.

Lending activity of banks and the granting of loans to enterprises

The bad economic and financial position of companies has not been an isolated problem; the effects hit the banking sector and the profits of banks were exhausted in 1992. In the present paradoxical situation it is getting harder and harder for companies to obtain sources of financing, while banks struggle with the problem of excess liquidity. Banks are very careful with lending procedures and apply strict qualification conditions to debtors and loans. Banks expect their customers to provide serious guarantees in the form of real property and movables, cash, government securities, joint and several surety, bank guarantee, etc. (Assets with indirect marketability are accepted as guarantee only below their market value.) The number of creditworthy companies is falling because of the bankruptcy procedures. The customers that are facing serious problems cannot get loans, not even at high interest rates. This is because the majority of banks are trying to cope with their extensive bad debts instead of increasing the number of their customers.

During the period of the recession the nominal value of the lending activity of banks has slightly increased, but the real value has significantly decreased in 1992. In September 1992 the number of short-term loans granted for the corporate sector increased by 9.8 percent and the number of loans with a term of more than one year increased by 11.4 percent (these figures being on the basis of the figures obtained a year before). As the total deposits of companies increased by 14.4 percent during the same period, the companies were net depositors. The total of short-term deposits increased while the amount of deposits with a term of more than one year dramatically fell. The reason is that the uncertain financing situation raised the demand for liquid assets.

In 1992, in the wake of the decline of the inflation rate, interest rates began to fall, albeit with a slight delay. However, deposit rates were reduced to a greater extent than the interest rates received by the banks and so the margin increased (see *Figure 1*). In addition to this the entrepreneurs applying for loans were encumbered with the fact that the increase of producers' prices was 10 percent lower than that of the customers' price. The most recent credit and deposit conditions are shown in *Tables 2 and 3*.

Table 2

*Loans for enterprises, offered by some banks from their own resources**

Banks	Checking account loan interest (%)	Short-term loan interest (%)	Loan interest longer than one year (%)	Single cost of handling (as a % of loan)	Security (as % of loan)
Agrobank Rt.	28–31	26–37	34–40	none	around 150
Budapest Bank Rt.	27.2–29.32	27.3–32.35	individual	0–2	125–180
Dunabank Rt.	35	29–33	39**	0.5–4.5	150
Kereskedelmi Bank	30–38	29–36.5	33.5–36	1.5–2.5	116–200
Magyar Hitel Bank Rt.	29	28–38	none	1–2	150–200
OTP Rt.	26–31	26–31	28–33	2	around 150
Reálbank Rt.	28	28	28	0.5	150–200

*Non-official figures
**No handling/administrative costs
Source: HVG (World Economy Weekly), 9 January 1993

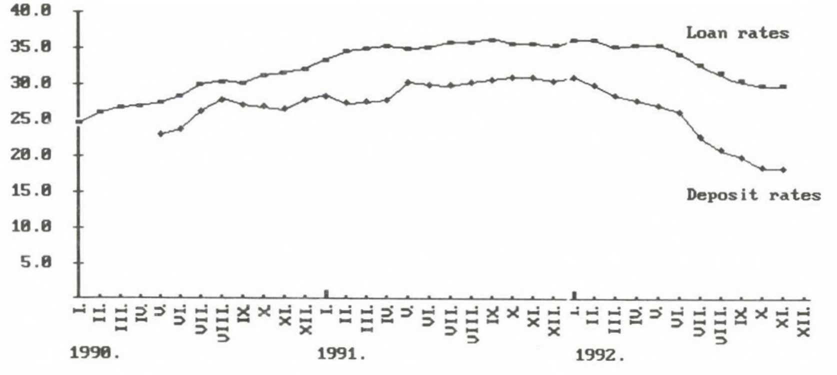


Fig. 1 Interest rates in the corporate sector (1990–1992)

High domestic loan rates have a dual effect on financing. Some enterprises still tackle the problem of expensive loans by trying to conduct business without loans. This way they "voluntarily" limit their own possibilities. But there is another option for successful companies. They might manage to obtain loans directly from foreign banks or companies at much lower interest rates. The number of for-

Table 3

Deposit rates of some banks in January 1993

Bank	Sight deposit	1 month	2 months	3 months	6 months	9 months	12 months	12< months
BB Rt.	5	15.00	15.50	16.50	17.5	17.5	17.5	
MHB	5	17.25	17.25	18.25	18.5	18.0	18.0	
OKHB	5	15.00	16.00	17.00	18.0	18.0	18.0	
OTP	5	17.00		18.00	19.0		20.0	21
MKB	5	15.00	16.00	16.00	17.0	17.0	17.0	17
Takarékbank	7	12.00		14.00	15.0			

Bank	Remark	Changes
BB Rt.	– valid from 20 January	none
MHB	– valid from 31 January – fixed interest rate ceiling – an amount over HUF 10 million can be deposited for a fixed period of six months for the usual interest rate + 1–2%	none
OKHB	– valid from 25 January – commission on the turnover of current account: 1.75%	none
OTP	– valid from 1 October until cancellation	none
MKB	– valid from 1 February – commission on turnover: 1.75%, minimum HUF 5,000 per one quarter year	2% reduction
Takarékbank	– valid from 1 October until cancellation – 18% for deposits already fixed for one year – commision on the turnover of current account: 2%	none

Source: Budapest Bank

eign exchange loans granted to Hungarian companies was estimated at USD 600 million in 1992, despite the MNB's (Hungarian National Bank) administrative restrictions (i.e. requirement of individual permission, the interest rate should not exceed LIBOR+2 percent, and the term should usually be more than one year). Decreasing interest rates on loans do not necessarily increase lending activity because lending out to companies who are in a critical position still remains risky. It does not make any difference to the bank whether the liabilities of a company are reduced or not if the company is insolvent.

The MNB has delegated the financing of short-term loans to commercial banks. Today the MNB is involved only in financing long-term loans with the purpose of development, and it provides the commercial banks with refinancing sources. These sources are provided in three forms and commercial banks lend them out in the framework of preferential banking products.

1. Lending out of funds received from international banking institutions

This category includes, for example, World Bank loans, which are usually linked with specific programmes (see *Table 4*). The central bank specifies a basic interest rate and transfers these funds to the banks. They add their independently specified margin (usually 4–5 percent) and provide the companies with loans. In 1993 World Bank loans are expected to be granted in the following fields: social security, health service, modernization of the taxation system, and the energy sector. The beneficiaries of World Bank loans may apply for additional sources up to the amount of 20 percent of the World Bank programmes and associated programmes provide the possibility for the involvement of small and medium-sized companies.

2. Transfer of sources obtained on the basis of the agreement made by and between the MNB and various foreign banks

This category involves loans for the specific purpose of purchasing imports (e.g. Swedish, Norwegian, Australian, Canadian) as well as loans which are for non-specific purposes, such as the now expired South German loans, the so-called Start loan and also the Japanese loan agreement, which is in progress. In accordance with the agreement made by the MNB and the Japanese EXIM Bank in December 1992, Hungarian small and medium-sized companies, individuals and joint ventures are eligible for loans up to the amount of HUF 8 billion (JPY 13 billion) for the purpose of development and modernization. The preparation of the specific agreements with the commercial banks that will provide such loans are in progress. Because of the expiry of the Start loans, there is an increasing demand for this loans for specific purposes, as the conditions are just as favourable (75 percent of the basic interest rate of the central bank + 2 percent margin) and the sphere of potential takers is even wider.

However, preferential loans of the recent period have not appropriately served those productive investments which have a relatively slow rate of return. During the one and a half years of the operation of Start loans the most popular fields of application were shops, restaurants, boarding houses, bars and also services in the field of education and the health service. The amount of the Start loans totalled HUF 10.5 billion.

3. Preferential loans with the purpose of accelerating the process of privatization

The so-called E-loan provides the possibility of purchasing state property using preferential loans, with the simultaneous requirement that a certain specified sum is deposited as a proportion of the amount of loan. The total amount of the

Table 4

Summary of the programmes financed by the World Bank; 30 November 1992

1 million World Bank dollars (WBD) and US dollars (USD)

No.	Credit taker	Name of the programme	Date	Loan code	Amount of loan WBD	Amount of loan USD	Tied* WBD	Un-tied* WBD	Called sum WBD	Called sum USD	Call-able WBD	Repayed WBD	Repayed USD	Amount of debt WBD	Amount of debt USD	Paid interest USD
1.	MNB	Corn programme	1983	2316–HU/A	130.4	197.1	130.4	0.0	130.4	199.6	0.0	65.2	96.5	65.2	103.1	91.1
				B	38.8	46.2	38.8	0.0	38.8	46.2	0.0	36.6	41.7	2.2	4.5	34.6
2.	H.STATE	I. Energy rationalization	1983	2317–HU/A	109.0	136.2	109.0	0.0	109.0	137.9	0.0	54.5	67.9	54.5	70.0	45.6
3.	MNB	Export development	1984	2397–HU/A	110.0	138.3	110.0	0.0	110.0	140.1	0.0	50.4	62.3	59.6	77.8	51.1
				B	24.0	24.0	24.0	0.0	24.0	24.0	0.0	0.0	0.0	24.0	24.0	17.7
4.	OKGT	Hydrocarbon programme	1984	2398–HU/A	90.0	111.5	90.0	0.0	90.0	113.1	0.0	41.3	50.1	48.7	63.0	40.9
				B	24.3	24.3	24.3	0.0	24.3	24.3	0.0	0.0	0.0	24.3	24.3	20.6
5.	MNB	Integrated stock-breeding	1985	2510–HU/A	80.0	85.2	80.0	0.0	80.0	86.6	0.0	26.7	50.1	53.3	58.5	16.4
6.	MNB	Fine chemistry programme	1985	2511–HU/A	73.0	80.4	73.0	0.0	73.0	81.8	0.0	24.3	26.2	48.7	55.6	24.3
				B	26.0	26.0	26.0	0.0	26.0	26.0	0.0	0.0	0.0	26.0	26.0	19.6
7.	H.STATE	I. Transportation programme	1985	2557–HU/A	75.0	85.0	75.0	0.0	75.0	86.5	0.0	25.0	27.9	50.0	58.6	26.3
				B	24.0	24.0	24.0	0.0	24.0	24.0	0.0	0.0	0.0	24.0	24.0	16.0
8.	H.STATE	Powerstation reconstruction	1986	2697-HU/A	64.0	66.7	64.0	0.0	41.5	44.2	22.5	16.0	17.0	25.5	27.2	3.0
9.	MNB	I. Industrial restructuring	1986	2700–HU/A	100.0	108.9	91.7	8.3	89.1	97.3	10.9	25.0	26.9	64.1	70.4	23.2
10.	MNB	II. Energy rationalizat.	1986	2709–HU/A	25.0	26.3	21.9	3.1	21.4	22.7	3.6	6.2	6.6	15.2	16.1	5.3

Table 4 *(continued)*

Summary of the programmes financed by the World Bank; 30 November 1992

1 million World Bank dollars (WBD) and US dollars (USD)

No.	Credit taker	Name of the programme	Date	Loan code	Amount of loan WBD	Amount of loan USD	Tied* WBD	Un-tied* WBD	Called sum WBD	Called sum USD	Call-able WBD	Repayed WBD	Repayed USD	Amount of debt WBD	Amount of debt USD	Paid interest USD
11.	MNB	Plant cultivation	1986	2738–HU/A	100.0	107.1	100.0	0.0	100.0	107.1	0.0	25.0	26.4	75.0	80.7	27.4
12.	MNB	II. Industr. restructuring	1987	2834–HU/A	150.0	151.3	98.2	51.8	111.0	112.3	39.0	25.0	25.3	86.0	87.0	26.7
13.	H.STATE	Telecommu-nication	1987	2847–HU/A	70.0	72.4	70.0	0.0	55.4	67.7	4.6	11.7	12.2	53.7	55.5	11.4
14.	MNB	Agroindustrial modern.	1988	2936–HU/A	70.0	71.2	45.6	24.4	44.4	45.6	25.6	0.0	0.0	44.4	45.6	5.5
15.	H.STATE	Sectoral restructuring	1988	2965–HU/A	200.0	216.1	200.0	0.0	200.0	216.1	0.0	0.0	0.0	200.0	216.1	59.5
16.	MNB	Technology development	1988	2966–HU/A	50.0	50.9	43.5	6.5	32.3	33.2	17.7	0.0	0.0	32.3	33.2	4.7
17.	MNB	III. Industr. restructuring	1989	3020–HU/A	140.0	141.8	49.9	90.1	39.4	41.1	100.6	0.0	0.0	39.4	41.1	5.5
18.	H.STATE	II. Transporta-tion progr.	1989	3032–HU/A	95.0	96.0	95.0	0.0	47.6	48.6	47.4	0.0	0.0	47.6	48.6	3.9
19.	MNB	Energy dev. (III. Energy)	1989	3055–HU/A	10.0	10.3	1.6	3.4	3.2	3.5	6.8	0.6	0.0	3.2	3.5	0.5
20.	OKGT	Energy dev./ OKGT	1989	3056–HU/A	100.0	101.0	100.0	0.0	35.1	36.1	64.9	0.0	0.0	35.1	36.1	2.2
21.	MNB	Moderniz. of financ. sys.	1990	3191–HU/A	66.0	66.3	58.9	7.1	29.3	30.2	36.1	0.0	0.0	29.9	30.2	1.4
22.	MNB	Global restructuring	1990	3228–HU/A	200.0	199.3	200.0	0.0	200.0	199.3	0.0	0.0	0.0	200.0	199.3	23.4

Table 4 *(continued)*

Summary of the programmes financed by the World Bank; 30 November 1992

1 million World Bank dollars (WBD) and US dollars (USD)

No.	Credit taker	Name of the programme	Date	Loan code	Amount of loan WBD	Amount of loan USD	Tied* WBD	Untied* WBD	Called sum WBD	Called sum USD	Callable WBD	Repayed WBD	Repayed USD	Amount of debt WBD	Amount of debt USD	Paid interest USD
23.	MNB	Integrated agric. export	1990	3229–HU/A	100.0	100.9	100.0	0.0	78.4	79.3	21.6	0.0	0.0	78.4	79.3	4.2
24.	MATÁV	II. Telecommunication	1990	3264–HU/A	150.0	149.5	150.0	0.0	13.2	12.7	136.8	0.0	0.0	13.2	12.7	1.4
25.	H.STATE	Human resources dev.	1991	3313–HU/A	150.0	150.7	150.0	0.0	13.2	13.8	136.8	0.0	0.0	13.2	13.8	8.8
26.	MNB	II. Restructuring	1991	3347–HU/A	250.0	258.0	250.0	0.0	175.0	183.0	75.0	0.0	0.0	175.0	183.0	11.4
27.	MNB	Company reform loan	1992	3459–HU/A	200.0	198.5	200.0	0.0	100.2	98.7	99.8	0.0	0.0	100.2	58.7	0.0
28.	MNB	Market development p.	1992	3509–HU/A	100.0	100.0	0.0	100.0	0.0	0.0	100.0	0.0	0.0	0.0	0.0	0.0
		Total		A	3057.4	3276.9	2757.7	299.7	2107.7	2336.1	949.7	396.3	473.4	1711.4	1864.7	528.3
				B	137.1	144.5	137.1	0.0	137.1	144.5	0.0	36.6	41.7	100.5	102.8	108.5
		Sum total			3194.5	3421.4	2894.8	299.7	2244.8	2482.6	949.7	432.9	515.1	1811.9	1967.5	636.8

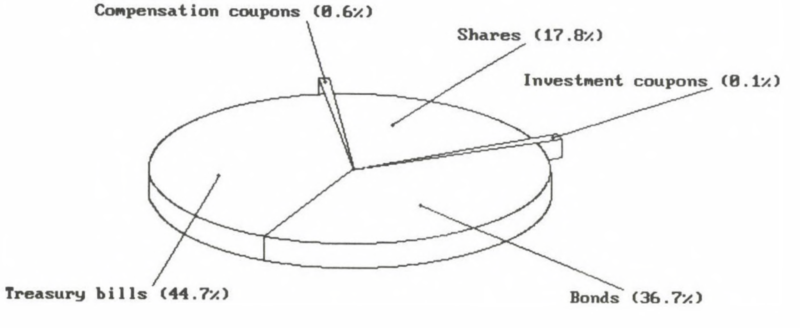
*Tied/Untied by domestic contracts

Source: MNB

loans granted in the framework of this possibility stood at HUF 6 billion in the autumn of 1992 (HUF 1 billion in 1991 and HUF 5 billion in 1992). This amount constitutes 10 percent of the privatization revenues. The conditions of the loan have become more favourable since 1 January 1993. The interest rate charged by the central bank was reduced to 3 percent and the margin charged by the broker banks was limited to 4 percent (however some offers included a 2 percent margin). The length of the repayment period was extended to 15 years and that of the grace period to three years. It is expected that the demand for the E-loan will increase as a result of the introduction of the new conditions. By October 1992 only 2,500 took the opportunity of taking up an E-loan. About 90 percent of the total amount of this type of loan was allotted to the purchase of shops, or the right of tenancy to a shop; the shops were offered in the framework of the pre-privatization programme (privatization of catering and retail outlets). The average amount of a single loan has been around HUF 2 million so far. Consequently this loan has mostly promoted the privatization of smaller enterprises. With regard to the E-loan, no credit limit was specified because the E-loan involves the conversion of state debt into private debt.

Credit activity may be intensified as a result of the formation of some new institutions (a loan guarantee corporation, investment companies, venture capital societies, and the introduction of a mortgage system).

The role of the security market in funding companies



Source: Budapest Stock Exchange

Fig. 2 Breakdown of turnover of the Budapest Stock Exchange (1992)

Table 5

The turnover of the Budapest Stock Exchange (21 June 1990–31 December 1992)

	1990 21.06–31.12		1991		1992		Total	
	HUF	%	HUF	%	HUF	%	HUF	%
Turnover (HUF 1 billion, double)	6.12	100.0	13.0	100.0	33.67	100.0	52.79	100.00
including:								
shares	6.12	100.0	12.7	97.69	6.01	17.85	24.83	47.04
bonds	–		0.3	2.31	12.36	36.71	12.66	23.98
treasury bills	–		–		15.06	44.73	15.06	28.53
investment coupons	–		–		0.03	0.09	0.03	0.06
compensation coupons	–		–		0.21	0.62	0.21	0.40
Number of transactions	4,962		14,509		8,565		28,036	
Number of average daily transactions	27		58		34		41	
Average daily turnover (HUF 1 million)	33.81		51.59		133.61		77.07	
Turnover per transaction (HUF 1 million)	1.23		0.90		3.93		1.88	

Source: Budapest Stock Exchange

The operation of the security market has been significantly affected by the economic recession, the high inflation rates, the high amount of the budget deficit and the growing uncertainty of the economic and political situation in the Eastern European region. The collapse of the Eastern European market has shaken the position of many profitable companies. This has hindered their flotation, and the performance of the firms listed at the Stock Exchange has fallen behind expectations. The supply of securities has not been significantly increased by privatization and the intensity of Stock Market activity has risen much slower than anticipated. Further development has been hindered by the low number of securities listed at the Stock Exchange (see *Tables 5–6*) and by the low liquidity rate of the securities.

Buying securities is not the most attractive form of investment in a period when interest rates are high. The demand for government securities is usually higher than the demand for the securities of companies, which involve a greater degree of uncertainty. In 1990 and in 1991 shares were by far the most popular securities, but in 1992 the security market was characterized by the dominance of government securities. By the end of 1992 the proportion of traded shares fell below 20 percent and this percentage might further decrease in favour of government securities (see *Figure 2*).

The issue of company shares is hindered primarily by the fact that only a few companies meet the requirements of the entry process at the Budapest Stock Exchange. In 1992 the shares of only four new companies were listed (see *Table 7*). It is expected that in 1993, in the framework of the privatization process, the rate of the issue of shares will exceed the figures of last year. The shares of specified firms can be purchased in exchange for compensation coupons. It is anticipated that firms involved in commerce, brewing, the hotel industry, the banking sector

Table 6

Turnover of the Budapest Stock Exchange in 1992
(HUF 1 million, double)

	Immediate transactions	Optional & futures	Total
Listed securities			
Danubius	0.16	0.00	0.16
Dunaholding	711.17	13.89	725.06
Fotex	2512.92	307.41	2820.33
Ibusz	833.60	38.61	872.21
Konzum	186.52	8.45	194.97
Pick	84.46	0.74	85.20
Styl	349.05	6.44	355.49
Sztráda-Skála	23.09	3.09	26.18
Zalakerámia	22.13	4.32	26.45
CA investment company	29.76	2.03	31.79
Total:	4752.86	384.98	5137.84
Traded securities			
Agrimpex	14.95	3.06	18.01
Bonbon Hemingway	14.24	0.46	14.70
Budaflax	21.89	2.80	24.69
Martfű	35.77	5.99	41.76
Főnix	2.35	0.50	2.85
Garagent	49.62	2.34	51.96
Hungagent	22.83	39.41	62.24
Kontrax irodatechnika	52.96	4.90	57.86
Kontrax telekom	31.01	2.76	33.77
MÜSZI	8.04	0.11	8.15
Nitroll	4.70	2.60	7.30
Novotrade	35.72	0.12	35.84
Skála-Coop	302.37	228.62	528.99

Table 6 *(continued)*

Turnover of the Budapest Stock Exchange in 1992

(HUF 1 million, double)

	Immediate transactions	Optional & futures	Total
Traded securities (continued)			
Terraholding	0.26	0.0	0.26
Government bond 1991/I.	10,775.36	895.09	11,670.45
Government bond 1995/A	644.67	10.26	654.93
Government bond 1995/B	24.17	0.0	24.17
Government bond 1994/B	3.62	0.0	3.62
Postabank I. bond	0.78	0.0	0.78
180-days Discount T-bill V.	1,127.47	0.0	1,127.47
180-days Discount T-bill VI.	1,271.54	98.88	1,370.40
180-days Discount T-bill VII.	1,788.72	92.87	1,881.59
180-days Discount T-bill VIII.	983.15	0.0	983.15
180-days Discount T-bill IX.	2,930.65	0.0	2,930.65
180-days Discount T-bill X.	609.58	0.0	609.58
180-days Discount T-bill XI.	1,525.54	0.0	1,525.54
180-days Discount T-bill XII.	53.99	0.0	53.99
180-days Discount T-bill XVI.	269.10	0.0	269.10
360-days Discount T-bill I.	2,258.12	156.85	2,414.97
360-days Discount T-bill II.	703.21	0.0	703.21
360-days Discount T-bill III.	1,198.82	0.0	1,198.82
Total (traded securities)	26,765.20	1,545.60	28,310.80
Compensation coupon	213.16	0.0	213.16
Sum total:	31,731.22	1,930.58	33,661.80

Source: Budapest Stock Exchange

and public utility services will have the greatest involvement in the privatization process in 1993. The success of flotation depends also on the appropriate selection of the various kinds of securities (preference shares, interest bearing shares, a combination of these, convertible bonds, and bonds providing the possibility of preemption right). Also, the favourable facilities of payment will be decisive factors. Such facilities proved to be crucial, for example, in the case of Danubius shares in 1992. Those who subscribed for Danubius shares had to pay only 10 percent of the value of the shares in cash, and were granted a six month interest-free loan for 40 percent of the value of the shares and were eligible to receive an E-loan with the remaining 50 percent of the value. An additional advantage was that each pair of shares kept for at least one year entitled the holder of the share to obtain one additional share free.

Table 7

Securities entered in the Budapest Stock Exchange in 1992

	Amount (HUF 1 million)	Date of entry
Shares:		
Főnix	165	13 January 1992
Skála-Coop T1	117.3	15 October 1992
Pick Rt	2,269.9	21 December 1992
Danubius Rt	8,000	23 December 1992
Discount T-bills:		
180 days maturity V.*	20,000	18 May 1992
180 days maturity VI.*	1,055	9 June 1992
180 days maturity VII.*	2,000	23 July 1992
180 days maturity VIII.	1,960	25 August 1992
180 days maturity IX.	2,000	8 September 1992
180 days maturity X.	5,000	9 October 1992
180 days maturity XI.	10,000	10 November 1992
180 days maturity XII.	10,000	10 December 1992
180 days maturity XVI.	5,378	31 December 1992
360 days maturity I.	5,000	23 July 1992
360 days maturity II.	5,000	9 October 1992
360 days maturity III.	15,000	31 December 1992
Investment coupons:		
CA investment company	1,740.5	29 May 1992
Bonds:		
Government bond 1995/A	15,000	22 October 1992
Government bond 1995/B	20,000	19 November 1992
Government bond 1994/B	30,000	31 December 1992
Compensation coupons:		
A, B series	20,000	1 December 1992

*Cancelled from the List of Securities

Source: Budapest Stock Exchange

The supply of securities is expected to increase because privatized companies and companies on the Stock Exchange have a great demand for capital and the interest rate on loans is still too high, despite the recent reduction.

There are signs that the bond market is recovering. Certain banks (e.g. OKHB) and some major companies (e.g. MATÁV) are trying to raise funds by issuing bonds. Some recent issues of bonds by private companies show the intensifying efforts of companies (e.g. Antenna Hungária Rt., Nemzeti Lósport Kft., Argenta Kft.; see NAPI, an economic daily, 22 January 1993) to enter the bond market. With declining interest rates, this method of obtaining sources may become more and more competitive.

Table 8

Investment companies (1992)

Type	CA Closed-end	Hunnia Closed-end	Buda Alap Open-end	Budapest Closed-end	Prémium Closed-end
Capital (HUF 1 b)	1.7405	min. 0.3	min. 0.5	min. 0.5	min. 0.5
Maturity (years)	5	3	–	3	3
Nominal value (HUF)	10,000	10,000	10,000 (+ combined denominations of 10 and 100 pieces)	10,000+ 100,000+ 1,000,000	10,000
Issue price (HUF)	10,000	discount, 9–13 Oct. 9,940	10,000	discount, 9–13 Oct. 9,970	10,000
First payment	31 Jan. 1993	1 Febr. 1993	None Reinvestment	A: Febr. 1994, AA and B: Reinvested	October 1993
Subscription:	–	8 June– 16 Dec.	17 August– 17 Nov.	26 October– 11 Dec.	9 Nov.– 4 Dec.

Source: Világgazdaság, 10 November 1992.

The significance of role of investment companies (see *Table 8*) is anticipated to keep on increasing in 1993. The total value of funds involved amounted to HUF 5 billion at the beginning of 1993. These companies increase the supply of securities on the one hand, and act as investors in the security market on the other. Most of them invest their funds in government securities but some of them choose company securities with low and high yield.

One of the decisive factors of the domestic capital market is that only certain sections of the market, and not investments in general, are encouraged. For example, certain investments—i.e. investment coupons and shares of primary issue—benefit from tax relief, in addition to the usual yield and appreciation. The purchasers of such securities may subtract the subscription value, and up to 30 percent of their income from the basis of their taxes in the year of the purchase; this is on condition that they keep the securities for three years. Closed-end funds are generally formed at the end of the year because the possibility of tax relief is of primary importance for the investors, and at the beginning of the year they do not know the amount of their income. However, the three-year limit is a significant setback. The securities of closed-end funds are going to be introduced on the Stock Exchange on the basis of the relevant law—but, because of the restriction regarding tax relief, their negotiability will be affected only by foreign investors.

Other techniques of obtaining funds

One of the problems of the privatization process in Hungary is that potential investors lack capital. The application of various funding methods, including the Employee Share Ownership Programme, the Management Buyout and the recently framed scheme of Privatization Leasing, might help to solve this problem. The Employee Share Ownership Programme and the Management Buyout provide the possibility of receiving preferential loans (as was pointed out above) and Privatization Leasing extends the application of leasing to the privatization process. These factors (and the controversial issue of the letter of credit) are the major elements promoting the formation of a network of domestic proprietors.

Leasing is a potential complementary form of funding. Although it is relatively new in Hungary, it is widespread. Leasing is not only a funding technique, it is a complex method of funding and obtaining possessions. The popularity of leasing is due to the fact that it provides extra services and tax relief: a part of the amount, or the full amount, of the calculated leasing fee is considered as a tax-deductible expense and it does not have to be paid from the taxable income. In 1991 the full amount of the leasing fee was tax-deductible, even if the term of the lease was less than one year. Consequently, the purchase of machinery and equipment in the framework of leasing was funded by the central budget to a significant extent, and the beneficiaries actually paid only 60 percent of the leasing fee. In 1992 the conditions were modified. In accordance with the new regulations the leasing fee calculated on the basis of lease contracts with a term of one year or less are not considered as tax-deductible expenses. The new regulations encourage the execution of contracts with a term of three years by stipulating that only 36 percent of the leasing fee (excluding ÁFA, i.e. general turnover tax) of tangible fixed assets, machinery, equipment and motor vehicles is tax deductible each year. The Act on Business Organizations regulates the leasing of property. Such lease contracts have a term of at least 8–10 years and the leaseholder is entitled to deduct 13 percent of the leasing fee (excluding ÁFA) from the tax base each year. In the case of import leasing 20 percent of the leasing fee for the year is added to the tax base. Import leasing is eligible for less tax relief because foreign interest rates, and consequently the leasing fees, are lower. At present there is no significant difference between the cost of leasing and buying on credit (however, the costs are subject to the prevailing tax relief and credit conditions). Nevertheless, the method of leasing has a special advantage. Only a few companies, and no individuals at all, can get long-term loans from the banks. For most of those involved in business, it is only the leasing that provides long-term loans (this is regardless of the fact that profitable companies have direct access to foreign loans).

No accurate figures are available regarding the prevalence of leasing. The Central Statistical Office have figures only for the year 1991 and only for the firms employing more than 50 workers. Experts say that at present about 10 percent of investments in Hungary are funded by leasing. (The relevant figure in Western Europe is 12–20 percent.) The estimated value of assets purchased by leasing in 1992 is HUF 25 billion.

In the case of privatization, the leasing fee is submitted to the lower interest rate of an E-loan. In the framework of this scheme privatization of property is promoted by the provision of both funds and security. The purpose of the scheme is to improve companies so that repayment of the loan can be ensured. The transfer of ownership is completed only after the repayment of the leasing fee. In November 1992 the State Property Agency selected eight companies to be sold in the framework of this scheme. The first contracts are to be signed in the near future.

Another complementary method for funding enterprises, particularly those involved in social services, is the raising of money by foundations. At the end of 1992 about 8,000 foundations were in operation with an estimated capital value of HUF 40 billion. About 40 percent of the income of foundations was in the form of gifts, 30 percent was granted by the central budget and 30 percent came from their business activity. Surveys made in 1992 say that 40 percent of the foundations are involved in cultural activities, 25 percent are involved in social affairs and health service and a significant percentage of the foundations are involved in environmental activity. It is obviously a possible method of funding the non-profit sector that is in the making. In 1991 several pseudo-foundations were formed for the purpose of avoiding taxation. From 1992 tax relief shall not be applied unless the tax authority declares that the foundation is of public interest.

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HUNGARY'S GROWTH PATH (TRANSFORMATION OR TRANSFIGURATION OF THE GROWTH PATH)

I. BEREND

The starting points of this study are underpinned by two assumptions:

— The growth rate characteristic of the growth path is a given condition in the long run and in global terms and, although it is not the most decisive determinant of the path, it is still one of its important characteristics.[1]

— Every economic growth path is characterized by some kind of marginal capital intensity, as expressed by the ICOR.

In the framework of this study, a complete description of the earlier and present growth path of the Hungarian economy cannot be undertaken—therefore, only a few elements of this path will be investigated.

A path that has come to an end

Let us make a détour within the détour! Before examining the recent past of Hungary, let us throw a backward glance at the growth paths of the earlier past.

In the period between 1848 and 1914, following the industrialization process of the modern world, significant railway construction was carried out in Hungary and, related partly to this, and partly to the development of agriculture, the industrialization process also took place. In the era of the Austro-Hungarian dual monarchy, the annual average growth rate of industry was between 3.0–4.0 percent; that of agriculture was about two percent. Both figures were considered to be significant in that period. In the second stage of that growth path—from the turn of the century up to World War I—the annual growth rate of the Hungarian national income was 3.2 percent; according to another computation it was 2.4 percent.

The other major growth path is the interwar period, namely the twenties and thirties. In those years the average annual growth rate of the national income was 1.5 percent, while that of the per capita income was lower, at 0.8 percent. This was because of the faster growth of the population.

In the case of each growth path, the turning points of the start, completion and passing onto a new growth path showed a significant similarity with the others. *The milestones were each time historical turning points and national catastrophies*:

[1] In my concept, the growth path is a form of movement of the economy which asserts itself in the longer run. It may be grasped more or less with the aid of quantitative parameters and also possesses certain characteristic economic strategical properties.

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thus the main role was played by force.[2] If, however, the growth path is determined by external force, we cannot tell what we would be capable of doing under our own steam, following the order of reason. Historical experience has shown that it is more expedient to yield to economic necessity than to the force of catastrophies. This lesson is valid even today, when analysing the tasks that have to be carried out in order to emerge from the present difficulties is necessary. Economic necessity is also coercion, but that of reason, not force.

The twenty-five or thirty years since the end of Word War II in 1945 up until the mid-seventies, constitute the third growth path in the economic history of Hungary over the last hundred years. I think that the statements of Ferenc *Jánossy* (1975) about this period are valid. According to him the years between 1945–1950 were ones of reconstruction and the growth path between 1950–1975—showing a high rate of growth—possessed similar properties. In those years an annual average growth rate around 5 percent proved to be a lasting feature. This was the highest growth rate ever recorded in Hungarian economic history. It was a very important historical phenomenon that, in a relatively short time, a fundamental macrostructural change took place: industrialization of the country (let us add: at a forced fast rate and not in conformity with Hungarian conditions), decline in the weight if agriculture (which was forcibly collectivized and, partly as a consequence, released labour) and the allocation of resources to infrastructure. The growth path was characterized over the three decades not only by a high growth rate, but also by continually rising average growth rates—that is, by acceleration. However, this was rather a property of the end of the path, not that of its beginning.

Characteristics of the Hungarian growth path 1950–1975

The first element of the path is the long term development of the rate of growth. Between 1950–1975 (at 1981 constant prices) the net domestic product increased in Hungary at an annual average rate of 5.4 percent. If, within this period, we examine the decades separately, we only find values which are at most 0.4 percentage points higher or 0.5 percentage points lower than the average for the 25 years. These are very small differences. Thus the width of the band of the growth rate can be well delimited.

The rate of growth in itself provides no information about the quality of the economy; but a significant and accelerating high rate or a lasting negative rate indicated a certain danger.

In the period examined the net domestic product declined relative to the preceding year in only three out of every four cases. In the first twelve years of

[2] World War I, dissolution of the Austro-Hungarian Monarchy, the Trianon Peace Treaty, Hungary's participation in World War II on the defeated side, with all its consequences.

the period, the 5 percent growth rate was the average of extreme changes (+23.02 percent from 1956 to 1957 and −9.07 percent from 1955 to 1956.) Later, the great fluctuations subsided and the significant 5 percent growth rate remained characteristic throughout. However, the "smooth" growth path is far from being really smooth, even if the growth rates of individual branches of the economy are considered. For example, the change in the industrial growth rate was +4.8 percent from 1978 to 1979, while it was −2.8 percent from 1979 to 1980. The rate of accumulation also fluctuated: while it was an average 15 percent between 1974–1978, it was half as much, 8 percent, in the preceding years.

Experts were already warning the central management in the late sixties that the acceleration could no longer be maintained in the seventies. In the early years of the next decade the country found itself in a critical situation, without any external pressure. This was to no small extent because central economic management neglected these signals; that is, it did not acknowledge that the growth path being followed had ended. In addition, the world economic crisis that erupted in 1973–74 also made a halt unavoidable; yet economic policy makers did still not draw the necessary conclusions. In spite of the world-wide crisis, the growth of the net national product was higher between 1974–1978 than it had been between 1968 and 1974. Expressed in another way, Hungary departed from the growth path followed until then, but not in the desirable direction. Surprisingly, the acceleration continued.[3]

Following the break of 1979, the growth rate fell by between one third and one quarter. The annual average growth rate between 1979–1986 remained noticeably below the earlier limits.

These figures indicate the derailment of the path, and the departure from the "band". Economic policy tried to bring about equilibrium radically, by means of a one-sided approach. Since it wanted to preserve living standards at any price, that is why investments were reduced greatly and in an unstructured manner. Efficiency requirements were neglected.

Marginal capital intensity

Another element of the growth path is the change in capital intensity. The movement of the average capital intensity (ACOR) is indicated in the short run by the changes in the marginal, incremental capital intensity (ICOR). The change in capital intensity is a highly characteristic element of the growth path.

In the period between 1950–1975 the two conditions of the high dynamics of the growth path were: a significantly high rate of accumulation and a globally diminishing capital intensity. The declining tendency did not indicate improved

[3]Mária *Augusztinovics* showed and published this point many years ago (1981a; 1981b).

efficiency but the fact that the infrastructural branches (both productive and non-productive) had been diminishing significantly.[4] This was the case even though the capital intensity of the material producing branches in the closer sense (industry, construction, agriculture and forestry) had been growing every year throughout 25 years.

In this sense, the phenomenon may be considered as a source of the primitive accumulation of industrialization. (By industrialization I mean not only the development of industrial branches, but also the introduction of industrial techniques and technologies into other branches. This was equally significant in industry, agriculture and construction, the most intensive process being the industrialization of agricultural technology.)

By the middle and the end of the seventies average capital intensity had diminished less on the macrolevel and the path was abandoned from the beginning of 1975. Both the average and the marginal capital intensities started to rise in the economy as a whole. It should be noted that a significant reduction of the rate of accumulation was only decided in 1978. Thus the marginal capital intensity still increased in the mid-seventies alongside a high rate of accumulation. As a matter of fact, a more precise interpretation of the capital efficiency of the material branches, particularly of industry, shows that the deterioration was at an accelerating rate.

While the capital intensity of industry increased between 1950 and 1970 by an annual average of 0.5 percent, in the seventies this was 2.3 percent and between 1979–1985 it had already reached 3.3 percent per annum. In the infrastructural branches capital intensity diminished in the fifties and seventies altogether by 4.5 percent; for the seventies alone this figure was a mere one percent. However, in the first half of the eighties it already reached an annual *increase* of 2.6 percent.

The change in capital intensity also indicated the derailment, and the timely abandonment of the limits of the "band" of the path.

The structure

The next element of the path, economic structure, is a problem with extreme ramifications. In this article, of course, I cannot examine its every aspect; thus I shall confine myself to a few statements, first of all regarding movements of the capital structure.

[4] This involved the decapitalization of the infrastructure. It does not mean the drawing away of capital, but under-development, and the reduction of investment. The ratio of infrastructural capital within the total capital stock was still above 81 percent at the beginning of the period, but it fell to 61 percent by its end. The direction and extent of this process are clear, in spite of several statistical limitations which prevent the presentation of a clear picture. For example, the valuation of homes, land, mineral resources, the capital elements of household plots and, in recent years, of the entrepreneurial workteams is rather uncertain.

The age of significant and stormy changes in macrostructure had come to an end by the mid-seventies. The sources of fast growth that had raised productivity (e.g. the flow of labour from agriculture into industry) had become exhausted. The weight of industry in the net domestic product increased between 1950 and 1970 from 20 to 36 percent, but the growth was uneven: after 1965 the ratio of industry only increased by one percentage point, while that of construction rose from 5.6 percent to a figure above 8 percent (declining, however, again after the end of the seventies). It was agriculture that underwent the biggest macrostructural change: its ratio fell from 50 to 20 percent by 1975. (For about ten years now, the share of agriculture has again been rising, if only moderately.)[5]

From the structural point of view, one of the most important characteristic features of the growth path has been the deviating and uneven structure of fixed capital and investment over past decades.

Thus, the disadvantage of the infrastructural branches has to a certain extent been moderated: the earlier lag of 24–28 percentage points fell first to 19 and then to 8 percentage points. All this is well illustrated by *Table 1*.

Table 1

Structure of fixed assets and investments between 1951–1985, percent

Periods	Share of: Fixed assets: Material branches in the narrower sense	Fixed assets: Infra-structural branches	Investments: Material branches in the narrower sense	Investments: Infra-structural branches	Difference between the investment and fixed asset shares of the material branches in the narrower sense
1951–60	18.7	81.3	56.1	43.9	+37.4
1961–70	26.6	73.4	54.1	45.9	+27.5
1971–75	34.7	65.3	49.6	50.4	+14.9
1976–80	38.3	61.2	50.8	49.2	+12.5
1981–85	38.5	62.5	46.1	53.8	+7.6

Source: Computations of the former National Planning Office

[5] At 1981 prices, the per capita net domestic product increased fastest in industry, followed by agriculture. The current net domestic product of the infrastructural branches is very high relative to 1950. However, this is not an achievement, for behind the figures we could find queuing at the counters of the foodshops, people left behind jostling at the stations of mass transportation, physicians not arriving on time, school classes with almost 40 students—in short, the growth was attained by the extreme exploitation of the infrastructure.

This tendency continued *in the early eighties*. The preponderance of industrial investments fell to 6 percentage points, and the share of agricultural investments was the same in the total investments as the share of agricultural fixed assets in the total assets of the economy. Thus for the first time, and over a period of several decades, the "investment disadvantage" of the infrastructural branches fell to about 5–6 percentage points. This was already enough to prevent a further decline in the weight of infrastructural fixed assets within the total of fixed capital in the first half of the eighties. Thus, in recent times the extent and dynamism of structural alterations has changed; the big shifts in structural proportions have come to an end. The tension between the proportions of investment and fixed capital has gradually been eliminated.

However, at the end of the high-rate growth path (more exactly, after its end) a new structural tension emerged between the basic material and energy producing industries as well as the manufacturing industries. Incomprehensibly, a development policy similar in character to that of the fifties once again came to the fore. From the late seventies investments, once again greatly exceeding the respective shares in fixed capital, were started in the basic material producing and energy industries. (The greatest burden was the massive government intervention aimed at saving the metallurgical industry.) As a consequence, the share of investment in manufacturing lagged behind the respective share in fixed capital. With the "under-development" of industries needing modern techniques and technology, the technological renewal indispensable for emerging from the crisis were placed in an extremely dangerous situation. Not one branch of manufacturing industry, could maintain its weight in total fixed capital, let alone raise it. Even the industries highly important from the aspect of modern technology (e.g. microelectronics) were disadvantaged.

Absorption of technical progress

The fifth element of the growth path is technical progress. According to a considerable number of growth theories (e.g. Harrod, or that of Tibor *Erdős* 1989) the most important determinant of economic progress—beside growing employment—is technical progress. I am myself of the opinion—and have expounded it in several of my writings (e.g. Berend 1987), that these factors decisively influence the growth path that is characterized with the growth rate. The line of reasoning of this article is in harmony with the determinant role of the first factor, since in the period examined the growth path of the Hungarian economy in general moved together with the development of employment: it increased up to the mid-seventies (with the exception of 1956–57 and 1961) and has been decreasing since then. The situation is more complicated as regards the second factor.

It is nearer the truth to say that in "follower economies" ***growth is not determined by technical progress, but by the capacity and readiness to absorb technology.*** Thus I consider the latter to be the decisive element of the path. (In developing my concept I was greatly influenced by the work of Ferenc Jánossy 1975). My experiences and research have convinced me that the rate of technological development does not depend on the materialized forms of techniques, but rather on their application—that is, in the last resort on the absorptive capacity. As Ferenc Jánossy writes: "the economic development of a country depends in the last analysis—that is, in the long run—on the evolvement of abilities inherent in the labour force..." (1975, p. 8).

Technical absorptive capacity and readiness are characteristics of every economy, and they develop under the combined impact of several factors. What is the technical absorptive capacity and readiness of the Hungarian economy? The degree of education of the employed increased in the period examined. It is certain that Hungarian workers and intellectuals today represent higher standards than in 1950—at least as regards completed schooling and the body of knowledge. However, it is my impression that in the field of general erudition and culture we have not made the same progress with regard to the expansion of knowledge. This reduces creativity, deteriorates technological discipline and keeps the workshop culture at a low level as well.

The absorption of technology is determined not only by the number of employed personnel but by the whole socio-economic structure. In present-day Hungarian society the ability of workers and intellectuals to recognize their interests is underdeveloped, while the possibilities for the articulation and assertion of interests have hardly become institutionalized. This restricts the willingness and ability of society and economy to absorb technologies.

I also consider the social conditions to be extremely important elements in establishing a growth path. Good political atmosphere, democracy, a safe "image" of the future, respect for human rights, assertion of progressive systems of ethics and values—in short, the ensemble of factors constituting social harmony—are highly important conditions for the growth path. These elements are apparently "cheaper" than those discussed up to now, yet they are more difficult to bring about. They do not require material investment, but the creation of social harmony which, of course, also assumes economic, ideological and cultural harmony.

Some lessons to be learnt from growth theories

If it is true that changes in capital intensity offer satisfactory information about the properties of the growth path, it would be worthwhile reviewing what economic theory has up to now been established in connection with capital intensity.

In a writing of this nature, of course, it is not possible to give a complete theoretical overview and detailed proof: however, in an earlier work of mine (Berend 1985) I have made efforts to deal with this task as well.

Nevertheless, I would like to remind readers that several deviating concepts have developed with regard to changes in capital intensity. According to Keynes, Harrod, Leontief, Solow and Samuelson, capital intensity does not change in the long run. Against them, Kuznets, Goldsmith, Perroux, and Clark argue that capital intensity was rising in the last century, while it has diminished in the present one. A UN study and an OECD forecast are in unison on the point that the overall capital intensity is at present rising primarily in the context of energy problems and environmental protection.[6] This is also supported by various forecasts that came from the former CMEA and the arguments of significant economists of the former Soviet Union (see e.g. OECD 1976). Thus it can be seen that economic theory has not satisfactorily clarified the direction in which, and extent to which marginal and average capital intensity changes are taking place at present.

I think that among the scientists investigating the problem it was Harrod who came nearest to the truth when he assumed that the development of capital intensity is, in the last resort, determined by the growth path. In accepting Harrod's theorem about the existence of a "natural growth rate", I am of the opinion—and later I shall try to prove it—that this also involves a natural marginal capital intensity.

Harrod's theorem is the equilibrium model where the growth rate of a definite path is equal to the quotient of the rate of saving and the marginal capital intensity. Erdős grasps the Harrodian idea in an interesting manner: "if accumulation grows, the natural growth rate does not rise while the marginal capital intensity increases" (Erdős 1989). Thus, if we wish to define the growth paths possible for our economy, we have to set out from the fact that the natural growth rate is associated with a natural marginal capital intensity, and this is secured by the natural rate of accumulation.

The forces that release transformation (transfiguration)[7] are partly economic, partly non-economic. In the second half of the twentieth century the latter group of factors have had a greater impact on the economies of the more developed countries.

Recent experience has challenged the use of the term "growth" and even more of the term "development". In intellectual circles, and mainly in those of artists the term "growth" is never used to describe today's situation, or desirable future situations. "Development" taken in a wider sense is perhaps accepted in a non-economic context. In such cases economists in vain point out that growth is

[6] In taking my stand I have received great help from a book of Tibor Erdős (1989) in which he interprets Harrod's equilibrium model. András Bródy called my attention to the fact that, prior to Harrod, Kalecki and, in a sense, perhaps also G. A. Feldman came near to the idea. Harrod used and further developed their results.

[7] The latter term is intended to convey an economic-philosophical meaning—i.e. a stronger care of transformation.

an internal technical term; it is accepted by virtually no one outside the discipline and not even by every one within it. Rather cynically, we might say that growth exists but its sign has been negative for some years and will be so for some time to come—but this cannot disturb the theory.

The abandonment of the nation of economic growth may also have been caused by the fact that quantities now mean different things than they did a quarter or half a century earlier. A rise in the average growth rate of the economy and its acceleration or deceleration, do not provide an unambiguous answer to the question whether the economy of a country and its society are developing or declining. It is also open to challenge whether the average growth rate of the economy is indeed shown by the GDP as an indicator. For example, a better indicator might be consumption or some figure showing the positive or negative change in the quantity of another economic product.

It is my supposition that, until a generally acceptable level of civilization and livelihood (changing, of course, in time) is attained, economic growth has a significant role in determining development. This role asserts itself perhaps until a situation is attained, on a massive scale, in which most people work and their place of work or own venture secures them the foundations of their livelihood without major risk (food, clothing and shelter); within and alongside this we can include schooling, culture, freedom of movement and, to a certain extent, assertion of the elementary human rights. Looking back at the past, growth has for some time now not been indicated by the quantity of material goods, but by their quality, and by the mode and circumstances of their acquisition and consumption.

This more complex nature of consumption, particularly the description of development and its judgement, can be more exactly expressed only with the aid of multi-disciplinary studies. Economic theory or, rather, the findings of expert articles show the "discipline-circles" and satellite studies emerging around the core of the profession. The quantitative changes in the factors of production no longer provide satisfactory explanation for the development of the economic growth paths. This could be provided precisely by the transformation-transfiguration of the factors of production (of the system of conditions). This change, or transformation-transfiguration of the factors may be considered the most important property of growth, and even more of development. The development of society and, within it, of economy may perhaps be well characterized by the changes (transformation-transfiguration) in the various processes, factors and the phenomena demonstrating the results.

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REVIEWS

JAPANESE BUSINESS ACTIVITY FROM A HUNGARIAN POINT OF VIEW

G. TÓTH

This article begins with a comparison between the Japanese and European way of marketing, both in domestic and international markets. It then gives a more detailed survey of Japanese business activity in Hungary. However, we have to realize that Hungary is of little importance in a global picture, so phenomena prevailing here can be misleading and not fully representative. Thus I have investigated the parallel structures in a leading EC country, the Netherlands. This nation is comparable to us in size, and is also one of the main advocates of greater European unification. Consequently the third part of the article attempts to keep track of Japanese business activity in Hungary and in the Netherlands, in order to show the relative weights, and to explore how important Europe can be for Japan. The results of a survey involving interviews with Japanese businessmen acting in Hungary and in the Netherlands are included in the account.

Crucial differences in marketing

The marketing gap in domestic markets

The life of a Japanese company is dominated by the ongoing effort to achieve first place in the area of industry with which it is involved. Competitiveness characterizes all aspects of business life, so new product development is a major point of consideration.

Another apparent distinction can be found in the functioning of distribution. Europeans and Americans got used to going to the smallest grocery store and selecting from many major brands; this would seem strange to Japanese eyes. In Hungary only manufacturers of the most expensive and highest ranked brands can afford to use exclusive distribution channels. This is not the case in Japan. It is a question of loyalty at every level of the distribution channel to deal with only one brand. Department stores are recent exceptions, but they cannot compete with the one brand distributors in many categories. Each Japanese manufacturer has an exclusive distributor chain and members would not dare to violate informal rules. The members feel commitment knowing that otherwise they could go bankrupt. In Japan, the number of brands you want to select from is equal to the number of stores you have to visit. This creates mutual dependence: manufacturers have to build up their own network and rely on it completely, because they cannot force others to cooperate. On the other hand, wholesalers and retailers have only one choice; therefore, if their manufacturer is not innovative enough to produce competitive products he will soon go out of business. These distribution channels are highly integrated: wholesalers and manufacturers are all members of the same "family", but might be fierce enemies of other "families". This interdependence contributes to the commitment a Japanese employee feels that he/she has towards his/her company, and the duty the employee has to make the company prosper and be number one. However, disadvantages also exist. In Hungary if a store is not satisfied with the turnover it can change products without any severe consequence. Apart from this lack of flexibility, high prices are also major issues from the consumer's point of view. Consumer prices in Japan are often double or triple those of American ones. These high prices, however, involve much higher after-sales service too. Any product which is defective can be returned to the manufacturer for repair or replacement, and the practice is similar with unsold products.

Pricing is a hopeless competition in Hungary with two digit inflation. The government tries to underestimate the inflation rate in order to encourage economic actors not to make price increases. The latter do not believe the forecast, however, and overestimate the inflation rate and adjust prices continuously in an effort to remain profitable. Customers in Hungary have got used to bearing price rises. This is the Hungarian way of price-quality association: if a price is constant there must be some problem either with the company or the quality. Expectations are major forces causing inflation. Japanese pricing is based on a totally different pattern. Prices should not change. As Mark Zimmerman remarked: "Price adjustment in Japan may be easier than surviving a leap from the Golden Gate Bridge, but only just." (*Zimmerman* 1987, p. 146) Such a long term decision needs a long and careful decision process too. Also, it is easier to plan and less likely that a big mistake will be made in an economy with 3.9 percent inflation.[1]

The fact that *promotion* and *advertising* are more intense in Japan than in Hungary should not be surprising, but Japan has even taken the lead ahead of the United States in the amount of money spent on advertising.

Yet another key aspect of Japanese marketing is strict quality control after sales service and luxury packaging. As mentioned above virtually everything can be returned to the retailer without any problem. Defective products are sent back to the manufacturer through the very same channel they came, because manufacturers are anxious to detect their own weaknesses. A form of consumer protecting organization led by Macuda Fumio has withdrawn 10 million cars since 1977 be-

[1] "The [Japanese] consumer price index in November is 3.9 percent higher than last year, which is the highest increase for eight years." (*HVG*, February 9 1991, p. 14.)

cause they did not meet the required security standards.[2] Aesthetical and beautiful packaging is also of vital importance for Japanese manufacturers, otherwise nobody would be inclined to buy their product.

The marketing gap in foreign markets

Institutional background: trading companies

Japanese trading companies are unprecedented formations that can be found in all corners of the world. To understand who it represents we need some information on another typical Japanese business formation: it is called *zaikai*, which literally means "financial circles". The *zaikai* is the cooperative network of a number of organizations having completely different profiles. The basis is built mainly upon manufacturing firms, but credit banks, insurance and shipping companies, data concerns and trading companies are members as well. The latter can be divided into two major groups: general trading companies (*sogoshosha*) and specialized trading companies (*semmonshosha*). There are thousands of specialized trading firms that are similar to western type export-import firms and which mainly act in domestic markets, so it is not important to get familiar with them in details with regard to Hungary. General trading companies are much more interesting. There are nine of these and each is a representative of a *zaikai* group in overseas countries. They represent 30 percent of the GNP and are experts in trading. They also provide opportunities to even the smallest manufacturer with no former experience in order to export successfully especially if it is a member of the same *zaikai*.

The old Hungarian centralized system had more similarities with the Japanese one than the new liberalized one, since all the sectors involved in exporting activity had a specialized trading company. They had some common characteristics with both the specialized and the general trading companies. They concentrated on a specific narrow market segment but represented a group of companies. However, unlike in Japan, these groups were not organized on the basis of traditional, prewar family connections and management congruency but on product lines. They also provided expertise but were less altruistic than the *sogoshosha*, using a 3–5 percent markup; in the case of Japanese general trading companies the corresponding figure is only 1.5–2 percent. In Hungary their operation was based on a legally centralized system: normal companies simply did not have a licence to engage in foreign trade. Thus they functioned inefficiently and the markup was too high; consequently, Hungarian firms were eager to get rid of this system and be able to do export-

[2] Toyota's enemy: "Japanese security standards are much lower than in Europe or in the United States. A small Toyota Corolla weights 60 kilograms less in Japan than overseas." (*HVG*, January 26 1991)

import activity independently. Under the new arrangements it is feasible for any organization to acquire a licence provided it meets certain requirements like having a tax expert, a foreign trade lawyer and statistician. Despite the new liberalization many firms have found that they are better off using an outside export-import firm. In Japan the cohesive power that brings manufacturers and trading companies together is informal and not formal as it used to be in Hungary. Many American and European firms realize that it is impossible to buy Japanese goods directly from the manufacturer. It is only feasible when the "management" of the *zaikai* group has decided that a manufacturer is "mature" and can act independently in foreign markets (this is a tough decision for the Japanese). A critical difference between Hungarian trading companies and their Japanese counterparts (i.e. the "*sogoshosha*") is their devotion to other group members and there is a mutually strong commitment between them. The only task of manufacturing companies is to produce goods. The trading companies gather information, investigate new and existing markets, do marketing research, and function as manufacturers' marketing advisors (although this situation has changed somewhat since many manufacturers feel it to be of vital importance to hold marketing in their own hands). They also buy all the production and pay the producer in yen. Handling the whole of the manufacturing surplus and dealing with more or less known and reliable foreign partners (they are not obliged to keep informal Japanese rules and are not preoccupied with tradition and togetherness within the group) general trading companies serve as risk takers who bear all the financial and business responsibility. Another one of their important roles is to develop natural resources in remote places for the Japanese economy.

These trading companies are the representatives and messengers of the Japanese economy; however they are fierce competitors as well. Not one of them wants to lag behind and they all enter the market together. (Every general trading firm has a branch in Hungary, but other forms of Japanese interest—like direct investment—seems to be less intense.) They smooth the way for smart Japanese gadgets and contribute to the idea of "Japanese, Inc." The *sogoshosha* can also be a useful means for Hungarian companies to export to Japan. Yet we need to be really careful when using Japanese trading companies. Japanese trading firms have often used the unfair strategy of importing western products to Japan, and then a *zaikai* member has copied it with some minor alteration in order to not harm legal protection. As soon as the Japanese competitor comes out with the low price copy, the trading firm ceases to offer its services or give advantages to the national product.

To summarize: the role of the Japanese general trading company is to serve the expansion of the whole economy *via* the manufacturers of its own *zaikai* group. The *zaikai* take a big burden off the shoulders of the manufacturers on both the input side (developing natural resources) and output side (selling products, taking risks and financial responsibilities).

Since the liberalization of foreign trade, in Hungary the activity of traders has been much narrower. Even if a company has a licence to trade it often lacks expertise and experience. Many of our big companies only have experience of trade with the former Soviet Union and other eastern countries, where product requirements were quite different from those of the western market. More often than not their only concern is profit, and sales volume is only a short term goal. If they can accomplish the most difficult task of making quality products, management problems will still remain. The most competitive companies are often subcontractors for Westerners and the State Property Agency tries to sell as many companies as it can to foreigners. It is a positive activity to speed up privatization, but it does not always take into account marketing considerations. Many western investors have come from Portugal, where competitive advantages—like cheap labour—decrease as that country approaches EC standards. Recently, in Hungarian-EC negotiations, Brussels and Budapest agreed on the fact that joining the European Community would probably take approximately 10–12 years for Eastern European nations. By that time Hungary's competitive advantages—from an investor's point of view—are supposed to have disappeared and consequently many investors will head east.

In Hungary if a company decides not to handle its export-import activity directly and does not acquire a licence it can employ brokers or agents. Selling agents usually do not take title to goods nor do they receive goods on consignment, and so unsold merchandise will be returned to the manufacturer. In fact, some agents do not handle products at all, just bring partners together and negotiate; for this they generally earn a commission. Companies with mass foreign trade can employ manufacturers' representatives, which is a relatively long term connection. These people earn a fixed premium and offer a kind of stability for the manufacturer representing company interests on a broader basis. All these agents operate as one-person marketing departments for the manufacturers. However, the main marketing function they perform is selling. Percentages and commissions mainly encourage them to go for a big sales volume. Indirectly, they are motivated to raise the company's image as it is much easier to sell a recognized and accepted brand than an unknown product. Nevertheless, increased image and brand recognition is not good for sales in the short run, since anybody is willing to buy a high quality unknown product and attach their own trademark or character. On the other hand, only a few are inclined to buy an unknown, Hungarian brand.

With percentages, agents are motivated to increase sales and not to raise the image of the company. This seems to be functioning well, but the final result is not as good as in the case of the Japanese *sogoshosha*. The solution is not to set up "Hungarian general trading companies" of course, because these would not perform in the same way as the original model. What is needed is long term thinking instead of short term, and concentration on marketing instead of selling.

Business strategies abroad

In Japan, aggressive overseas trade expansion began before World War II, in the early twenties. Japanese strategy employed almost everything that American laws (such as the Robinson-Patman Act or Sherman and Clayton Acts) and business ethics prohibit: copying products, pirating brand names, predatory pricing and dumping. Very low quality characterized unreliable Japanese products, and this remained the case after the war. It was American occupation that helped Japan, for that was the time when an American guest professor, Edwards Demming, demonstrated how to improve quality control. The Japanese proved to be good students and nowadays nobody is able to make better quality goods than they do in many fields. Thus the first strategy was quality improvement.

Japan's unique location contributed to its isolation, and the sea is the only way to conduct large scale trading. Japan recognized this early and acted. Thus shipbuilding became a most progressive industry there and Japan managed to gain shipping dominance in the far East. It has a number of major ports: Chiba, Nagoya, Kawasaki, Osaka, Tokyo.

Japan also became dedicated to knowing everything about the developed regions of the world and it started to set up information networks. She not only used traditional methods but also collected a mass of intelligence data. These networks are still functioning but now concentrate on collecting business and market information, and not military information. Industrial espionage by the Japanese is not unusual in the USA. Mitsui and other *zaibatsus* have huge networks for information gathering.

Having acquired the ability to make quality products, gained shipping dominance and established proper information networks *via* trading companies Japan started heavy advertising abroad. The government plays a decisive role in this process. One of the most significant supportive government bodies is JETRO (Japan External Trade Organization). It facilitates information-gathering and lobbies actively for Japanese firms all over the world. Lobbying is legal in the United States—not like in Hungary—and the Japanese are aware of this. Toyota alone has 26 law firms in the federal capital. Andrew S. *McFarland* (1984) writes in the introduction to his book on lobbying:

"Over 2500 trade associations and professional groups now have headquarters in Washington D.C., and most of them have chosen this location to facilitate their efforts to lobby the legislative and executive branches of the federal government. Other groups not located in Washington, are represented in the capital by one or more of the thousands of lawyers, public relation experts, and outright "lobbyists" who attempt to influence the policy process for fee."

We can take it for granted that the Japanese are among them. The Japanese government is also one of the biggest market researchers, and it examines business opportunities and selects targets. Using these sources, it supports certain industries in order to achieve the set objective. For example, if they decide that they should break down IBM's leading role in the computer field, all the major competing computer manufacturers have to collaborate and be involved in joint R & D programmes involving huge expenditures. It is called industrial targeting. We may well envy the Japanese since their government has the power to achieve given objectives, but also because that government has a well supported target system with well-defined, clear goals. It is really an advantage.

A comparison of the Japanese presence in Hungary and the Netherlands

Overall background

Japanese foreign expansion takes two different forms: direct investment and export.

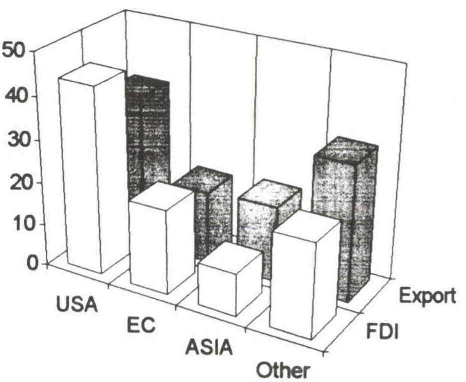

Fig. 1 Japanese export/FDI in the period of 1986–88 by main region[3]

This figure shows that the distributions of Japanese exports and foreign direct investment are similar. However, the differences are very informative. In the period shown the USA was the most affected country, followed by Europe.

Hungary and Eastern Europe are among the "others" on the chart, where exports are still ahead of the investment. The Japanese are just getting acquainted

[3]This figure is based on data from *Table 5* and *Chart 5* of the research paper by Gorota *Kuma* (1989) for the Ex-Im Bank of Japan.

with the region, and the changeable rules and conditions make them cautious. A detailed regional distribution of foreign trade in 1991 can be seen in *Figure 2*.

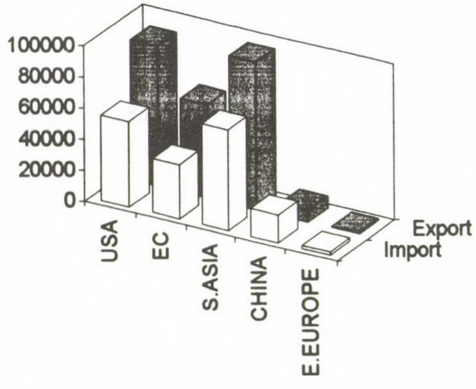

Fig. 2 Japanese foreign trade with major partners in 1991[4]

Comparing this chart with the previous one, significant changes can be seen. Japan feels that the American market is less promising so it is trying to dominate its closest competitors, the parvenu "little tigers" of Southeast Asia. The European Community's share has also increased and so has that of Eastern Europe. It is interesting that less developed countries like China or the former Soviet Union were the only ones where Japan had a negative trade balance, Eastern European export volume (747 M$) is also close to import volume (616 M$). We can be proud of this fact, considering Japan's recent huge trade surpluses. However, it is in fact evidence of the obsolete structure of economy, for the Japanese imports are comprised of raw materials and semi-finished goods. Expert opinions on the Hungarian economy present a general situation that is confusing, dark and almost seems hopeless. At the same time the pessimistic forecasts are still better than other Eastern European countries, and Hungary is regarded as the best reformer, and Hungarian changes are much faster than elsewhere. With regard to the trade balance, if we make a conclusion that a negative balance means less raw materials oriented for export to Japan, and thus a more competitive structure in industry, Hungary took second place in the region after Poland. The latter shows a more

[4]This chart is based on figures from the table of the annual report of the Hungarian Republic's Embassy (1992).

negative trade balance/trade surplus from a Japanese point of view and higher trade volumes in 1991:[5]

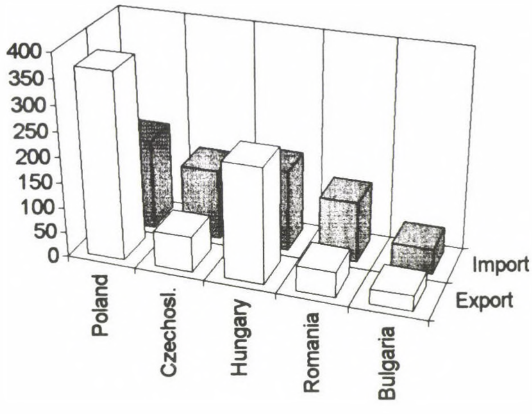

Fig. 3 Japanese trade with Eastern European countries in 1991

Foreign trade

Japanese-Hungarian trade connections

The first Japanese connections in Hungary were those of the trading companies. At the time of writing 13 general trading companies were operating in Budapest (most of them came in the seventies). Not all of them are among the "big nine", and if we classify trading companies in terms of annual turnover then six of them can be referred to as "big": namely, C. Marubeni Corp., Mitsubishi Corp., Mitsui and Co. Ltd., Nissho Iwai Corp. and Sumitomo Corp. Their annual sales amount to over 100 billion dollars and all have offices in distinguished locations in Budapest. There are also three "medium" size general trading companies in Hungary with annual sales of approximately 60 billion dollars: Kanematsu Corp., Nichimen Corp. and Tomen Corp. The four "small" general trading houses include Koshin Bussan K.K., Okura & Co. Ltd., Toyota Tsusho Corporation and Kyowa Hakko. They all play an important role in Hungarian exports to Japan.

[5]This chart is also based on figures from the table of the annual report of the Hungarian Republic's Embassy (1992).

170 Hungarian companies exported products to Japan in 1991; however, the operation is very concentrated, and the ten biggest companies accounted for 80 percent of all exports. By the same token eight of the ten biggest exporters were the same in 1990 as in 1991. Hungarian exports have constantly increased over the last decade. This is a welcome process but we do not have the Japanese "surplus problem". What we have to look out for is the structure of Hungarian exports. It is likely that materials such as iron, semifinished goods (e.g. tubes), and agricultural products (e.g. fruits) have a too high proportion. Hungarian imports from Japan have a much higher volume. The latter figure was 338 million dollars in 1991. As has been discussed, monopolistic trading firms are changing or running out of business. New trading companies colour the scene but the ten biggest importers lost markets shares: a 26.2 percent loss in 1991, 47.7 percent in 1990 and 59.2 percent in 1989. Recently established Japanese companies have also offered stronger competition.

Import volume is growing steadily but proportions remain much the same. Over the past two years machines have occupied roughly two-thirds of the whole import range. This includes (in order) video players and recorders, metal-working machine tools, calculators and electronic cashiers, telephones, facsimiles, TV sets etc. Not far behind machines are chemical products, films and basic raw materials (with no substitutes in Hungary). Vehicles are next in the line: cars, trucks, motors. The last major category comprises copiers, watches, diagnostic tools and spraying syringes.

Japanese-Dutch trade connections

All *sogoshosha* have their subsidiaries in the Netherlands (they run only offices in Hungary). They are mostly located in fashionable centres in Amsterdam and Rotterdam, and they operate in diverse fields.

Total export and import volumes are depicted in *Figure 4*.[6]

Comparing this chart with the Hungarian total trade balance with Japan (see *Figure 6*) two major differences catch our eyes. The first is volume. The Dutch exports were eight times those of Hungary to Japan than, and import thirty-two times greater. Dutch-Japanese trade does not only have deep roots but flourishes these days as well. Japan also has a trade surplus with Holland and this huge deficit is obvious from the figure. In the connection with the comparison of Eastern European economies given above (*Figure 3*) it was suggested that a negative trade balance with Japan could reflect the degree of economic development. Most industrialized countries have expensive resources and agricultural products which do not attract the Japanese, but the populations of such countries provide markets

[6] This chart is based on data from statistics of the Japan Tariff Association.

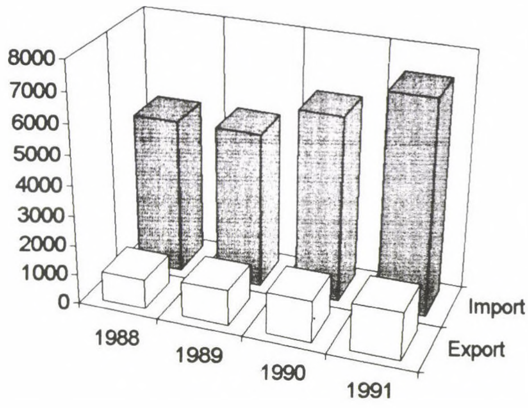

Fig. 4 Foreign trade of the Netherlands with Japan in 1988–91

worthy of strong efforts. The result is a negative trade balance for the country and the Dutch example demonstrates this well.

A year earlier manufactured goods represented the biggest share of Dutch exports to Japan (62.7 percent). Within this group chemical goods (mainly organic, medical and pharmaceutical products) dominate, making a quarter of total exports. Machinery accounted for 15.5 percent (general, electrical and transportation) of exports, and 19.1 percent were foodstuffs (fish, shellfish, milk sugar, cocoa, milk, cream, cheese, curd and other dairy products). Other major groups are textile and metal goods, books, newspapers, works of art and antiques and photographic films. (JETRO 1991)

Import groups from Japan were led by heavy and chemical industry products (87.7 percent) in 1989. The main group was machinery, representing more than three quarters of Japanese goods targeted to Holland. Other subgroups of high significance were electronic automatic data processing and other office machinery, video equipment, TV cameras, sound and other audio-visual equipment, line telecommunication equipment, precision instruments and transportation equipment. The remaining 10.2 percent was comprised of light industrial goods: magnetic tapes (blank), musical instruments, tires and tubes. Raw materials, fuels and foodstuffs were not significant. (JETRO 1991)

This picture portrays the interaction of two highly developed nations, but the structure of Japanese industry appears to be much more up-to-date and competitive. Japanese exports are clearly dominated by high-tech products that require less labour and more machines, and involve increased research and development activities. We can find such items among Dutch export goods as well, but Holland seems to have a foothold in traditional industries like agricultural and horticultural products.

Direct investment

In Hungary

Japanese interest in establishing manufacturing projects in Eastern Europe is not significant, but what interest there has been has certainly favoured Hungary. In fact, Hungary is the only Eastern European country where a really large-scale Japanese project is on the way to realization: the Suzuki car assembly plant.

"Although investors say they find Hungary the most attractive country for investment in Eastern Europe, they add it is distant, unfamiliar, and surrounded by unstable neighbours."[7] Suzuki is the only Japanese firm involved in large-scale projects in Eastern Europe and the size of its capital represents 1.3 percent of the 20 largest investments made in the region. This makes it the seventh biggest. It's definitely the largest Japanese project in Hungary. The National Bank of Hungary reported that in the middle of 1991 Japanese direct investment totalled 80 million dollars, and of this Suzuki Rt. had invested 70 million. What is the motivation for coming to Hungary?

Suzuki seems to be making a long term plan and is trying to establish a foothold in Europe. Conditions have changed since Suzuki representatives started to negotiate with the Hungarian government, and competition has become sharp since the early eighties. As a compensation Suzuki was offered—along with Ford—short term preferences: tax and other advantages amount to a 22.5 percent cost benefit for these car manufacturers. The Japanese have also received a government guarantee for the investment and 100 million HUF from the employment fund. Car makers do not look for short term money, so government preferences can facilitate a decision but are unable to alter it. Since the emergence of a less favourable Hungarian domestic market—car import liberalization has loaded Hungary with western-made cars—Suzuki now wants to enter the Western European market, and gain a 30 percent market share in Hungary. To avoid protectionist restrictions the "made in Hungary" five-door Swifts have to include a 60 percent + proportion of Hungarian components. Searching for proper suppliers has been difficult for the Japanese investor because only 22 of the 700 Hungarian companies that applied for a sub-contract could meet the quality requirements specified by the manufacturer. Consequently, 20–30 percent of the components is far from the required 60 percent, yet Suzuki people want to reach the latter figure by 1995. Accumulators, seats,

[7] *HVG*, October 5 1991, p. 79 (Source: *The Economist*).

cables glass, paint and brake parts of Hungarian origin are of adequate quality. Privatization of potential suppliers using Japanese capital is a possible alternative. Progress has been made in this field, and the Mitsuba Electric Co. has sold a licence to the Bakony Művek so it can produce windscreen wipers for Swifts. Mitsuba is also helping Bakony to modernize its electronic product line. Suzuki is working and at the same time waiting to see what happens. If market conditions become favourable the Magyar Suzuki has a good chance of turning into a bigger operation.[8]

Three other Japanese manufacturing firms have started important operations in Hungary.[9] Salgótarján Glass Wool Ltd. manufactures materials for filters and insulation. Polifoam, a Japanese-Hungarian joint venture, is on the way to making its brand name a generic product name in the same way as Aspirin (although the latter later ran into difficulties). The fourth, AGROFERM deals with fermentation technology for agricultural products. These companies approached Hungary after consultations with the general trading houses during the eighties.

The latest company to enter the field is Aranyolaj Rt., whose profile is also connected with agriculture, being involved with the processing of vegetable oil. Suntory, one of the biggest Japanese firms in the alcoholic beverages industry, is the major shareholder of Grande Millesimes de France. The latter has established a joint venture with the Tokajhegyi Állami Kombinát for growing grapes.

Returning to high technology, a number of camera and film makers are operating in Hungary. Nikon Trading Hungary Ltd. is a one hundred percent subsidiary of Nikon Europe BV. (based in the Netherlands) and possesses exclusive rights to sell Nikon products in Hungary. However, it does not plan to establish its own distribution system. Canon Inc. and Fuji Film have branch offices and the Goko company is about to start assembling in Hungary. 35 percent of the company stock is in Hungarian hands, and the cameras would be exported.

Suzuki might be the most serious but not the only Japanese automobile manufacturer with Hungarian plans. The Toyota Motor company established its "Hungary Ltd." with one hundred percent Japanese owners (Toyota Motor Company 50 percent, Toyota Tsusho Corp. 50 percent). They tried to sell twice as many vehicles in 1992 (2000) as they had in 1991, and have seven outlets in their own dealers' network. Nissan has also set up a joint venture—Nissan Hungária Rt. in October 1991—and is making strong efforts to build up its own distribution and dealer network. They have two exclusive dealers at the moment but would like to have eight by the end of 1993. Nissan knows that solvent demand is increasing in Hungary so the demand for cars will decrease as well in the short run, but will rise in the long run.[10] Honda Motor Co., Tokyo has made a contract with the Hungarian trading

[8] *HVG*, February 29 1992: Suzuki: Hungarian or Japanese? pp. 7–10.

[9] The source of information on existing and planned joint ventures and branch offices is the Annual Report of the Hungarian Embassy in Japan, unless otherwise specified.

[10] A conference of the Hungarian Marketing Association was held in Sopron between 23 and 25

company Interag in order to establish its own venture to sell Honda vehicles and machines (motors, small machines for gardening and generators). Other representatives and profiles in this area include Matsushita Electric Industrial Co., Japan (TV, microwave ovens, telephone systems), NEC Corporation (semiconductors and computers), and Shimuzu Hungary (construction).

Banking and financing are also progressive areas; the Central-European International Bank Ltd. is a classical bank of Japan, and Daiwa-MKB (Hungary) and Nomura Invest Bank Hungary Ltd. are already dealing with investments and securities. Real estate and land prices are extremely high in Japan so many Japanese institutions make investments of this kind overseas.

Hungary has also become a centre for research and development activity. One result of this is that the Furakawa Institute of Technology has bought a part of the Physics Research Institute (KFKI).

In the Netherlands

Holland has a prestigious status in the world with regard to Japanese direct investment. In the years 1989–1991 it was always among the 3–4 biggest recipients of Japanese capital: in 1989 the USA had 48.2 percent of it, the United Kingdom 7.8 percent, the Netherlands 6.7 percent, and Australia was close with a 6.3 percent share. During the next year Australia overtook Holland and the ranking remained constant in 1991.[11] Wholly owned subsidiaries show an outstandingly high proportion in the Netherlands (61.5 percent), along with the United Kingdom, Ireland and Belgium.[12] Foreign direct investment normally takes the form of manufacturing sites and research and development bases. Forty four Japanese affiliated manufacturing companies operate in the Netherlands. The ratio of stakes held by the Japanese varies a lot, from 10 percent to full ownership. The average capital of a company is 34.62 million Dutch guilder, which is roughly 20 million US$. The average number of employees is 274, and 1.5 percent of these are native Japanese. These averages are arithmetical mean values, and therefore one huge company distorts (increases) the results. This is the Netherland Car B.V., whose shareholders are the Mitsubishi Motor Corporation (1/3), the Dutch Government (1/3) and the Volvo Car Company (1/3). Netherland Car B.V. employs 55 percent of the total workforce in 44 companies, and possesses 41 percent of the total capital.[13]

April, 1992. Morio Matsumara, vice president of Nissan Europe N.V. spoke about Nissan's global and European strategy.

[11] Statistics of Japanese Ministry of Finance.

[12] 8th Survey of European Operations of Japanese Companies in the Manufacturing Sector, Table II–6, pp. 13–14.

[13] Ibid. The calculation of mean values is from "Japanese enterprises in Europe", pp. 153–156.

The next section will look at what motivates Japanese companies to come to the Netherlands, as well as their marketing activities. This is done by means of survey results conducted in Hungary and the Netherlands.

Survey consequences

In Hungary

I attempted to conduct a survey to find out the Japanese motives for coming to Hungary—i.e. opinions, feelings, expectations, fears and opportunities. Questionnaires were sent to a number of organizations: Japanese-Hungarian joint ventures, Japanese companies registered in Hungary, liaison offices and representations. It comprised 50 questions. Questionnaires were in the English language and we appealed to the highest ranking Japanese employee to complete it.

Responding companies were in trade, not manufacturing, and employed 10 to 20 people. They normally had one Japanese employee, and this was the manager. They believed that only Japanese could fulfil top level management positions, but the other employees should be Hungarians. Only one respondent felt that Hungarians could attain top managerial positions. The reason for coming to this region was the Hungarian market itself, and not the relatively good commercial links Hungary had with former socialist countries. In their opinion Hungary's Association Agreement with the EC makes this country more attractive for Japanese companies. Hungarian labour is supposed to be relatively cheap in certain areas "but the matter is not so simple" and labour cost shows a gradual upward trend.

At this point I would like to make a short interruption in the analysis of responses: the cost of labour is a much debated issue in Hungary. There was no doubt that it used to be comparatively very low by European standards, and it still is if we consider disposable income. However, additional burdens like social security tax must be paid by the employer, and these are outstandingly high in Hungary, making an employee at least one and a half times "more expensive" than he/she really is.

To return to the survey, respondents considered preferences offered to foreign investors relatively high in Hungary, but this played a major role in deciding to invest here in only one case. The most debilitating elements of Hungarian infrastructure were cited as roads and telecommunications, but these can be improved in 5–10 years. Japanese top managers have fewer communication problems with managers within the company than with partners, employees and the general public. It seems that we do not have to worry about languages if we stay in Hungary since they think they should learn Hungarian in order to work at full capacity in Hungary. (Of course people are not so positive abroad.) Respondents suggested that financial difficulties plus thick red-tape are the most urgent problems to solve, although political stability has increased over the past two years. Hungarian suppliers have deficiencies to overcome with the organization of production; this means preparation, normative aspects, and workers' job education must be improved. Japanese managers reside in Hungary with their families, but they are not so enthusiastic about Hungarian food.

Japanese investors first invest money to trade—manufacturing comes afterwards. They really think globally and would like to take advantage of the progressive Hungarian market; however, European unification also has a great impact. They not only work in Hungary but are really interested in the country and even inclined to learn a language that they can only use here. Infrastructure, knowledge of foreign languages and administration have space to develop, as well as the quality standards of Hungarian manufacturers. The Japanese are more optimistic about political stability in Hungary then we are. We can surmise that these investors are not disappointed and will be followed by others.

In the Netherlands

A somewhat modified but basically equivalent survey was sent to Japanese manufacturing companies in Holland. I quote the results alongside another survey which was conducted by the Japanese External Trade Organization (JETRO) in 1991. This covered Japanese manufacturing companies in 18 West European countries. (JETRO 1992) (In this section references point to the respective places in the JETRO survey, if no specific reference is given to my survey.)

Regarding markets, all respondents were motivated when coming to Holland by a "presence in Europe", and not only the Dutch market itself. In the Benelux union companies mentioned their five top motives as "to meet expanding demand" (1.), "to meet consumers' needs" (2.), "to meet a rise in trade protectionism resulting from the EC's market integration" (3.), "to benefit from the expansion of economic activity resulting from the EC's market integration" (4.), and "investment incentives such as tax credits" (5.). (p. 17) In accordance with the broad European orientation, companies sell only 0–10 percent of their output on domestic markets. The bulk of goods are aimed at the whole of the EC. Only 0–15 percent goes to non-member European countries. On a European scale more than nine tenths of the firms export their products from the countries in which they operate. 53.1 percent of the firms export more than half of their products. (p. 39) In Holland they perceive no legal restriction concerning distribution.

Firms in Southern Europe gave second place to the "labour cost is lower" factor when deciding where to start operating in Europe. (p. 19) The Dutch survey also asked respondents to mention some countries where labour is cheaper (replies:

Ireland, France, UK, Italy, Spain) and where labour is more expensive (replies: Germany and Norway).

Infrastructure is well developed in general, with telecommunications and telephones being regarded as outstanding. Health care has room for improvement but every element of the infrastructure got a rank ranging from 1 to 3 on a 7 grade scale. The European survey also found that "good infrastructures and favourable geographical conditions for physical distribution top the list of reasons for selecting specific European countries to penetrate." (p. 19)

Regarding qualifications, skills and foreign languages the Dutch are a step ahead us. Communication problems are not relevant but increase in number as one moves from the company management to partners, employees and the general public. Returning to motives for coming to a certain region, "English speaking managers" holds first place in Northern Europe. (p. 19) The ideal solution is seen by Japanese managers as "we should communicate in English" (3) or "we should learn Dutch" (1). Dutch physical workers are considered to be properly skilled so Japanese companies can find enough workers. The period of training of a new recruit ranges from two weeks to a year, but the average is 1–2 months. Dutch managers practice the desired managerial techniques. First, medium and top level managers should all be Dutch nationals, but Japanese like to keep top positions for themselves, too. European findings are similar: "locally recruited people assume directorship or higher positions at more than 50 percent of the firms surveyed." (p. 53)

The next section dealt with operation and marketing. Companies in Holland use Dutch suppliers in only 4 percent of cases. Minimal objectives regarding local suppliers is to acquire 20 percent of parts but one company's aim is to reach 80 percent. Increase of the local content is one part of the localization efforts made by the Japanese. Some firms find no deficiencies with Dutch suppliers, but others do and answers are too dispersed to draw conclusions. 60.4 percent of European Japanese companies are not satisfied with local parts suppliers. The usual reasons for dissatisfaction with local services are quality, price and delivery. (p. 50) Dutch organizations all expressed the desire to have an independent marketing strategy. European companies, however, are far from being totally autonomous: 89.9 percent answered affirmatively to the question: "Are the intentions of your parent company reflected in local units?" (p. 55) Regarding their marketing mix, firms in Holland concentrate on product and quality. Half of them work together with an outside consulting firm.

Personal infrastructure is also better in the Netherlands than in Hungary. Every respondent had been with his family for five years on average. The Japanese school in Amsterdam, the American school near the Hague, and other international schools provide proper education for the children. Food and amusement possibilities are satisfactory as well.

Before making conclusions some words can be said about the representativeness of the Dutch survey: sample mean capital was 17.67 million guilders, population mean is 34.62 million, sample mean employees numbered 120.7 (this is 274.1 in the whole population). Still, I believe the survey was representative, since one giant company (the Netherland Car B.V.) distorts mean values by making the decreases that I have mentioned.

Lessons can be found when comparing the surveys. The Japanese have come in the hope of finding the world's biggest market. The biggest welfare states (Benelux and Northern European countries) have disadvantages like high profit taxes and expensive labour forces, although advantages outweigh these factors in the form of highly developed infrastructures, good education facilities, and consequently decent foreign language skills. Thus trained workers require approximately a month shorter period for job training etc. The net result of these factors is the attractiveness of these countries for Japanese capital. We should keep in mind those advantages and try our best to avoid combining the disadvantages of leading and lagging EC members: unsatisfactory infrastructure, unbalanced higher education, high taxes in every sphere, and small welfare services. We should avoid these not only for the sake of the Japanese but also for our own good.

Conclusion

The growing dominance of Japan in the world economy should teach us to study the Japanese as they studied the United States at a time when "made in Japan" meant about the same for an average American as "made in Hungary" does nowadays.

A deep marketing gap helps us realize that we have to learn to make high quality products even if it requires the complete restructuring of our economy. We cannot copy the most elaborate Japanese distribution network but it can be concluded: every manufacturer is responsible for the products he makes, and every middleman is liable for the goods he sells. Prices must be calculated with care, and promotion efforts intensified. Long term thinking is the most important type of economic behaviour to get acquainted with. Employees have to feel commitment to their company, employers for their workers, manufacturers for their channel members and customers, trading companies for their organizational clients, and banks for the companies. The government's role should be to facilitate changes, smoothing the way and providing only some guidance. It should not force the economy and kill companies with strict regulation, taking away profits, and implementing bureaucratic red tape. Economic and welfare considerations must have priority over politics.

Having a glance at Japanese foreign trade and direct investment in different countries we must admit that Hungary is of relatively small importance. However, there is evidence of progress and our chances have become much better since the liberalization of Eastern Europe and the forthcoming unification of the European market. Hungarian imports from Japan are bigger in volume and more up to date in structure than Hungarian exports. However, we also export some highly processed and quality products like medicines and tools. This asymmetry is more the result of Japan's high-tech than our low-tech, and the same asymmetry can be seen in Dutch-Japanese trade connections, (although to a much smaller extent). We have to increase the absolute volume and the relative proportions of high value added products. The Japanese strongly appreciate European culture and by implication they consider Europe to be the source of expensive luxury goods. Four tenths of European sales in Japan involve products of small-volume turnover at exceedingly high prices. We also have to look at the import structure and try to make imported goods in Hungary, with Hungarian workers, out of Hungarian materials and with recognized Hungarian brandnames. I know that, for instance, the idea of competitive Hungarian cameras might sound ridiculous but market niches always exist. Japanese strategy is always to capture the "low market" and climb up after assuring strong positions there. Japanese cars are still cheap but are not only in the cheapest category: even Mercedes and BMW have to face Japanese competition. This strategy will not harvest big profits in the first stage, but it could be extremely successful in the long run. I do not think that we have to make special efforts to attract Japanese direct investment to Hungary since these are national goals too. Lower inflation, political stability, modern education, reliable telecommunications and highways are conditions that Japanese investors will be happy about, but much more beneficial for ourselves.

In my opinion Japan's purpose was more to be the first industrialized nation in the world but they realized that trade is the pivotal means to accomplish it. "Keeping up with Europe" is a noble goal but no goal can be achieved without looking for the way to it. We have to clarify which system we would like to apply and be consistent. An ill-fated mixture of the strongest American market motives and elements of Eastern European communism will not create an economic upturn. The Japanese way is not impossible for other nations—the little tigers and the ASEAN countries have proved it. Even the poorest countries of East Asia are ready to develop: Bangladesh and North Korea think it is possible to catch up with their neighbours. We have better basics and we must believe it.

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COMMENTS AND CRITICISM

HUNGARY'S PLACE IN THE WORLD

L. SZAMUELY

Éva Ehrlich: *Országok versenye 1937-1986. Fejlettségi szintek, struktúrák, növekedési ütemek, iparosítási utak* (Competition between countries 1937-1986. Development levels, structures, growth rates, industrialization paths.) Közgazdasági és Jogi Könyvkiadó, Budapest 1991. 231+1 p.

The title of the present review is not intended to draw attention to some new product of meditation on the "eternal Hungarian" fate. Nowadays the latter are once again multiplying. This valuable book by Éva *Ehrlich*, as distinct from romantic lucubrations, is indeed about the theme indicated in its title (beside many other things). In other words, it is about where Hungary is situated in the *real* world—from the point of view of its *actual* state of development, and with regard to results of economic changes that have taken place over the last half a century. All this is considered in a framework which includes our Central and Eastern European fellow-sufferers.

To be even more precise, the book is a summary of scientific research that has been carried out during the last thirty years. Perhaps the lay reader would not suppose that the history of this expert and objective analysis of dry statistical data exemplifies in itself the vicissitudes of Central and Eastern European development; however, without this knowledge the message of the book cannot be interpreted in the light of its true importance.

Habent sua fata libelli

This ancient adage—that books also have their own fate—is in some way suitable for this particular book; yet perhaps the adage is more appropriate for the antecedents of its writing and publication. Namely, Éva Ehrlich has utilized the method elaborated by Ferenc *Jánossy* (who was the initiator of the research project) and then she has completed it.

In the late fifties Jánossy, working at the National Planning Office, elaborated a relatively simple method for comparing the economic development levels of different countries. The method set out from the empirical fact that there is a certain—usually positive—relationship in every economy between the level of development and the per capita consumption of various goods. For example, in more advanced, more industrialized countries the consumption of electric energy or animal proteins is higher, there are more cars and telephones, the flats are bigger and better supplied with public utilities. Since the per capita consumption or stock of various goods can be found in the national statistics—expressed in physical units of measurement—it is also possible to estimate the volume of consumption of the observed goods that accompanies, on international average, the per capita national incomes of the countries, expressed in dollars or another currency. The great idea of Ferenc Jánossy was to reverse this relationship; namely, he attempted to draw conclusions from a sufficiently large number of physical consumption indicators for different countries in order to establish the relative level of development of these countries. In effect, he was able to state their ranking by-development level. His book (Jánossy 1963) presented his method and the computations for 26 countries (among them Hungary), indicating their development levels for the year 1955. His work was accepted with great appreciation by the profession. Yet by that time Jánossy's interest had already turned to other economic problems; nevertheless, his method was further developed and applied with great consistency in the following decades by his colleague Éva Ehrlich.

The history of vicissitudes actually begins here. As is known, the international comparison of economic development levels became a fashionable topic from the late fifties onwards, for several reasons. Ehrlich indicates three reasons in her book. The first one was the growing mutual dependence of national economies; the second refers to the international recognition of the danger entailed by the widening abyss between the developed and the underdeveloped parts of the world; and the third one was the appearance of the socialist "camp", which was using methods and indicators of statistical observation that were totally different from the usual international standards. However, the latter—a seemingly technical difficulty—affected interests which were extremely sensitive from ideological, political and even world power aspects.

The dictatorial systems that brought about "existing socialism"—in order to become legitimate—were under compulsion to prove the thesis—to be traced back to Marx—that under socialism the productivity of labour is higher than which can be attained under capitalism. Since most of the countries that called themselves "socialist" had earlier belonged to the periphery of the developed world, the rapid development of their economies indicated a path for a break-out of poverty and offered a development pattern for the backward countries of the Third World. However, the catching up with, or even outstripping of the economically more developed countries had to be proven statistically. It is thus not surprising that in Soviet statistical data a dual process began during the late twenties. This is when the task of catching up became embodied (on paper) in the Stalinist five-year plans. On the one hand, the actually published statistical data became ever more scarce and regular publications ceased right up until 1956; on the other, the aggregated indicators of economic growth, such as the national income or the gross social product—both computed according to their own methodology—testified to extremely large rates of growth. The same road was covered after World War II by the statistics of those Central and Eastern European countries that claimed to be "building socialism"—albeit with some deviations by some countries.

To prove the "catching-up" process, Soviet-type statistics, calculated on the basis of a specific methodology and operating with internationally incomparable synthetic indicators, showed a preference for natural indicators in terms of physical units of measurement. These usually originated from the field of heavy industry, which enjoyed development priorities. It was characteristic that when *Stalin* spoke in 1946 about the long-term plans of development (this speech was referred to in the official propaganda as *the* programme for building communism), he listed millions of tons of crude iron, steel, coal and crude oil to be produced; yet he did not even mention, for example, grain (Stalin 1946). In the wake of the "catching-up" campaign, declared again by Khrushchev in the late fifties, the statistical yearbooks of the Soviet Union for a long time included a standing chapter on the comparison of certain physical indicators with the corresponding American ones. Naturally, the yearbooks also published extremely favourable synthetic indicators of developments which could not be checked.

In the west, first of all in the United States, researchers used a very costly method employing a large apparatus (the so-called "repricing method") in order to make the Soviet synthetic economic indicators comparable. The Soviet volume indicators were converted, with the aid of American prices, with reference to the widest range of products. Thus they attained various and always debatable results. Later these methods became more refined and diversified, but they remained costly.

Using Jánossy's method, Éva Ehrlich worked out—first for the year 1960—the relative levels of economic development for 28 market economies and eight Central and Eastern European countries (including the Soviet Union and Yugoslavia). The result did not verify official opinions. However, since official "comparable" figures were missing (apart from the Soviet Union), this was not yet a stumbling-block. The scandal occurred when Ehrlich compared the figures obtained for 1960 with the 1937 development level of the countries in question (with their per capita GDP), and worked out with the same method. That is, she extended the application of Jánossy's method from spatial comparison to comparison over time. The growth percentages thus obtained differed from those published by the statistical offices, including those of the Hungarian Central Statistical Office. The Hungarian officals could not pass over this fact in silence.

This is the explanation for the curious fact that, scrutinizing the list of references of the book being reviewed here, it turns out that *prior to its publication there had been no full-scale "open" publications in Hungary* of Éva Ehrlich's findings. This is in spite of the fact that in professional circles her research has been well-known and appreciated for many decades. However, the publications of the Institute for Economic Planning of the National Planning Office, marked "for internal use", were not for general circulation. The debates were for decades conducted behind closed doors and only some vague suggestions became public.

It is interesting to use lists of literature to show how the contents and their concomitant taboos gradually, over recent decades, became eligible for publication.

From the late sixties there is no doubt that Hungary became the most liberal country of the "peace camp"—regardless of the extent to which today's Hungarian officialdom makes efforts to deny this fact. Yet such denial had its place in those days too, but for a different reason: it was in order to prevent the leaders of the "fraternal countries" from becoming irritated and thus reproaching the Hungarian leadership for this liberalism. The Hungarian leadership, in the end left alone with its economic reforms, followed the principle of "liberalism in one country". It more or less allowed the publication of the results of social science research which had a domestic bearing, but made efforts to prohibit every publication which contained reference to other countries showing information at variance with the official data produced by those countries.

It is thus understandable that Ferenc Jánossy's book published in 1963 showed only Hungary among the countries compared. (According to their own personal accounts, Jánossy and Ehrlich had already made some computations for the Soviet Union and a few other Central and Eastern European countries, but they dared not put them on paper.) As mentioned, in the mid-sixties Éva Ehrlich had already included eight of the then socialist countries in her international comparison, but only the computations relating to Hungary and Czechoslovakia were actually published. The latter appeared in an English-language periodical of the Czechoslovak Academy of Sciences, in 1966. Nobody could object to that, as it could then be considered an internal affair of Czechoslovakia. Finally—partly as a consequence of the Czechoslovak publication—computations relating to all countries could be published, but again not in Hungary: in fact, they appeared in a publication of the UN Economic Commission for Europe. Similarly, no objection could be raised against it by the Hungarian leadership as this was an international publication and, in addition, an organization in which all the "fraternal" countries concerned participated. Thus, in principle, the publication was made with their consent.

In the mid-seventies Ehrlich then completed the comparison with reference to the year 1970. This, too, was circulated—not openly, yet within a definite professional circle—as a publication of the Institute for Economic Planning of the Planning Office. It again provoked a scandal behind closed doors. This time it was the then hard-liner leadership of the Institute, who aspired to promotion to higher positions, that passed a harsh judgement on the research of their own colleague. This was because her results showed lower levels of development and, following that, lower growth rates for the socialist countries than the official ones. This is why Éva Ehrlich finally left for the Institute for World Economy of the Hungarian Academy of Sciences. A further improvement in Hungarian public affairs was reflected by the fact that a periodical—*Gazdaság* (Economy)—published computations that were held to be scandalous and which had appeared in a study written by Éva Ehrlich and her co-worker, Gyula *Pártos* (who has since died, passing away at an early age). (Ehrlich and Pártos 1979)

Even this publication was not full-scale: the computations relating to the Soviet Union were omitted, but those covering the smaller Central and Eastern European "fraternal" countries were included. It seems that the gradual easing of the doctrine of "limited sovereignty" (attributed to Brezhnev) meant that in the field of publications one could initially only write about one's own country (with limitations, of course); later, one could also write about the smaller "brothers" (cautiously), however, it remained throughout inadvisable to write about the very big "brother". The latter was the ultimate and, at the same time, last taboo.

Even so, the story had yet another, tragicomical, twist. Namely, in the mid-eighties Ehrlich computed the states of development for the year 1980. The trouble with this was that at that time Hungary was already a member of the International Monetary Fund and the World Bank, and the Hungarian government—as later became common knowledge—had "fed" false data into the world organizations. Although the direct falsifications were related to the stock of debts, from the point of view of various facilities to be obtained and the contributions and membership dues to be paid, the size of the Hungarian GDP in terms of dollars was not indifferent. The government considered it to be in the country's interest to have the lowest possible GDP and have this accepted by the international organizations. The trouble with the computations made by Ehrlich, using physical indicators, was precisely that the GDP computed by her was too high—at least in comparison with the figures deemed to suit the purpose of the Hungarian government. At any rate, even if the sign of official displeasure had changed, the consequence was the same—namely, the publication was prohibited. The verdict was passed by the then government factotum of international economic relations—the execution was left to the leadership of the Institute for World Economy.

After such antecedents it is understandable why we can learn the full-scale findings of the researches in Hungarian only now, after the change of political system. Yet instead of happily finding a safe berth, in all probability it is history which has poked out its tongue at the authoress. The change of system was faster than the publication of the manuscript, which had been completed at the end of the eighties. (The foreword is dated February, 1990.) Namely, during the two years idled away by the publisher (Közgazdasági és Jogi Könyvkiadó) the real magnitude of the lag of economic development level, which the researcher had tried to point out over several decades, became distinctly visible to everyone. This is a consequence of opening up towards world market, of economic liberalization, and the disappearance of the CMEA market. History has verified the truth of Éva Ehrlich's research findings sooner than the public at large could have learnt about them.

Certainties and open questions

When analysing the research findings of Éva Ehrlich, the first thing that needs to be said is that the advantage of international comparisons based on physical indicators is not that they produce more exact or more authentic results than methods that operate with value indicators. This refers to the methods already mentioned, which relied on repricing or on the comparison of purchasing power parities of currencies of different countries. The amazing fact is precisely the minimal deviation of Ehrlich's GDP computations for 1980 from the results of four other international computations based on value indicators (the comparison is found on pp. 57–64 of the book). Of course, this also means that—as the authoress puts it: "as regards the question about GDP/capita and development levels, no exact or unambiguous answer can be given with any of the hitherto known methods." (p. 61.) That is, doubts and objections may be voiced against every known comparison, and these are equally justified.

The computations performed with the Jánossy-Ehrlich method possess three kinds of advantages over the comparisons made with the aid of value indicators:

a) This is the fastest and least costly procedure. This is at the same time an explanation for the fact that Éva Ehrlich has been capable of producing, practically alone, internationally fully "marketable" results for three decades.

b) The international comparison by countries of the per capita consumptions of products in physical units of measurement provides an opportunity for the analysis of economic structures.

c) The comparison of levels of development over time—i.e. the measurement of economic dynamics and of growth rates—also becomes possible.

With regard to the *concrete results* of the computations reviewed in the book, due to the approximative nature of the measurements, it is not the ranking of the countries or their relative position that are worth pondering on, but the tendencies that took shape over the course of half a century. I would stress three tendencies from among the processes presented in the book.

The first is the tendency, also stated by other disciplines, that *the development levels of the industrialized countries have come closer to each other*. On the one hand, the difference between the two most developed North American countries and the European countries and developed countries of the Pacific has diminished. On the other hand, the distances in development levels between the European countries themselves have become smaller. For example, the difference in the development level of the most advanced country within the European Community, the FRG, and that of the second least developed one, Greece, diminished from 3.6 in 1960 to 2.6 by 1980. The tendency of approximation also holds for the Eastern European countries. The differences in levels of their development in comparison to the most advanced ones—the USA and the FRG—everywhere diminished relative either to the pre-war figures of 1937 or to those of 1960.

The second tendency is that the countries of Central and Eastern Europe—that were earlier called socialist—*continue to be situated on the periphery of the developed industrialized world*, even if the distance imaginarily separating them from the most developed ones has become smaller. According to the situation in 1986, Hungary precedes only the Balkan countries and Portugal among the European countries (which does not include the former socialist ones). As a matter of fact, this corresponds to the situation in 1937, with the not unimportant difference that at that time Hungary also preceded Spain in respect of her development level and was only slightly lagging behind Italy and Japan.

The third tendency—which pushes the picture even further to the negative side—is that *the countries nearest to us in respect of development levels—i.e. Austria and the Southern European market economies—have developed faster than the countries that were called socialist.* Thus, even if the gap separating us from the most developed countries has diminished, it widened relative to Austria and, from among the Southern European countries, Spain has overtaken and surpassed us, while our advantage over Greece and Portugal seems to be disappearing.

Perhaps the most instructive part of Ehrlich's book is represented by the figures which show why the sacrifices borne by the peoples of the socialist countries over many decades in order to make up for their lag in development level proved to be relatively unsuccessful or only slightly successful. This refers to the relationship between the size of per capita consumption (utilization) in physical units of measurement, and the international norms corresponding to the given level of development. According to the computations by the authoress (pp. 108–109), in 1980 the small Eastern European (socialist) countries consumed, in order to produce their GDP and relative to the international average, 86 percent more steel, 118 percent more sources of energy, 29 percent more cement, 55 percent more zinc, 71 percent more fertilizers, but 31 percent less packaging paper. The corresponding consumption of the Southern European market economies, which were developing faster than the socialist countries, was at the same time lower than or close to the international norms.

Such wasting of resources (which includes overemployment and for which ample data can be found in the book) also entailed shortages; these are structurally and very markedly reflected in the *backwardness of the infrastructures* in every Soviet-type economy. It is highly interesting how, when analysing the historically different growth paths in the last chapter of her book, Ehrlich points out that it was only characteristic of the first industrializing country, England, that the ratio of those employed in industry increased in a way that preceded every other sector—although it reached a peak with 47 percent and thus did not become preponderant within total employment. In the later industrializing countries—the USA and Japan are quoted as examples—the service sector grew together with industry, and even faster, while the ratio of industrial employment peaked at 35 percent and then began dwindling. As against these facts, the Stalinist model of industrialization followed the British road of a hundred years before, thus creating a stunted service sector that could not answer the demands of a modern society. The authoress is quite right in stating that for a successful modernization the Eastern European countries have to change their model of economic development, and this demands a painful structural transformation.

This book is thought-provoking and rich in ideas. The ramifying analyses of the authoress provide ammunition for several kinds of interpretation, even for debating her own conclusions. Thus, knowing the negative facts stated by her—which are by no means fully reviewed here—the conclusions of Éva Ehrlich's computations raise some doubts as to whether the level of economic development of the (former) Soviet Union is (was) higher that the average of the small Eastern European CMEA countries (p. 75); in more concrete terms was it and is it higher than that of Hungary? What is more, in the ranking of countries for 1986 (pp. 66–67), not only the Soviet Union but even Bulgaria significantly precede Hungary in respect of their development levels.

It is not our intention, nor would it make sense, to call the authoress to account for the unusual placing of this or that country (e.g. why Belgium and Luxembourg seem to be more developed than the Netherlands by 10 points—taking the level of development of the USA as 100). As we have stated in the introduction, the method only produces results that are of approximate exactness. Nevertheless, the development level of the Soviet Union is significantly higher than that of Hungary throughout the computations (Bulgaria received a higher ranking only for a single year—for 1986). In the book even the authoress herself offers quite a number of data which seem to contradict the result obtained.

Yet let us first raise a question of principle. Can a country be considered developed which cannot feed and clothe its population according to the European minimum standards, nor can independently extract the richest mineral deposits on earth? The answer would be less certain if we take into account that this country maintained the biggest army in the world in terms of staff, and whose armory was first class by all standards with regard to modernity (the maintenance of the armoury and readiness for combat are different questions). That is, we have come to the traditional question: what do we measure? The question holds not only for the Jánossy-Ehrlich indicator of economic development levels, but also for the accepted GDP/GNP ones. As a matter of fact, even the latter mainly reflect the inputs, not the results—namely, the results of the services are measured by the costs, since no other measuring rod has yet been found. Let us leave aside further traditional questions: i.e. do military expenditures increase or consume national income and does ordnance production increase or decrease the volume of useful goods? As is known, these products drop out from the circulation of reproduction: they cannot be used either for personal consumption or as means of production.

These are not abstract, academic questions in the case of a country which spent, in peacetime, a proportion of its social product systematically on military purposes to an extent never seen before. In other words, it squandered it. (Recent Russian estimates of military expenditure move between an unbelievable 20–30 percent magnitude of GDP.)

The physical consumption indicators taken as a basis by Éva Ehrlich are mostly specific *input* indicators (e.g. steel, energy, cement, metals, stock of tractors, fertilizers, freight-ton-kilometres, number of physicians and hospital beds, postal turnover in terms of letters). Thus the computations make conclusions on the basis of inputs. True, it is an indispensable element of the method used by her that it draws conclusions from the international trend (norms) on the concomitant levels of development. It ignores the figures of some countries that deviate significantly from the international trend. However, the figures are taken from the official national statistics and the deliberate and/or unintended falsifications cannot be sifted out by the researcher. For example, it is common knowledge that in Soviet statistics lard is also included in meat consumption (the indicator of animal protein), and that the quantity of cereals or electric energy shows, in the best case, only the produced and not the consumed volumes. Namely, nobody deducts the huge wastage.

Of course, Éva Ehrlich is fully aware of that. She indeed shows (pp. 80–81), for instance, that the growth rates computed by her for the years between 1937–1960 are essentially in line with the official indexes in the case of the market economies; yet in the case of the so-called socialist countries they are systematically lower than the official ones. The difference is smallest in the cases of Yugoslavia and Hungary: 19 and 21 percent. The greatest, almost twofold, difference can be found precisely with Bulgaria and the Soviet Union. In the period between 1960–1980 (p. 83) the official data of Yugoslavia and Hungary stood again nearest to the computed ones, while Romania led in the size of its deviations. So much for the quality and reliability of statistics...

However, with regard to the deviations of the specific physical consumption values from the average international norms (already mentioned), according to the computations by Ehrlich (p. 115) Hungary stood—together with Yugoslavia—about midway between the wasteful consumption of the other smaller socialist countries and the international average. Her economy was thus operating with better efficiency than that of the others. The data of the Soviet Union are missing from this comparison but we have no reason to assume that her specific indicators were better than, say, those of the GDR or Czechoslovakia. Also, if the Hungarian degree of efficiency was significantly better—thanks to the 1968 reform, which is now proclaimed to have been a failure, and even ignored as if it never existed—then, according to the figures obtained, why was the level of Hungary's economic development lagging so far behind those of not only the GDR and Czechoslovakia but even of the Soviet Union?

The open and international market assessments of the national economic performances which are now taking place after systemic changes, and in extremely grave circumstances, justify, in our opinion, at least the asking of the question.

Yet even if the answer secured a more advantageous place for Hungary in the international ranking, it would continue to be in the group of those lagging behind—let us hope, only for the time being.

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BOOK REVIEWS

MIHÁLYI, P.: *Socialist investment cycles: analysis in retrospect.* Dordrecht: Kluwer Academic Publishers. 1992. xvi+233 p.

Introduction. One of the most discussed issues of the socialist economy is whether there were investment cycles?[1] There are two groups whose members give a negative answer: the first group consists of dogmatists who deny the existence of cycles because cycles would contradict the so-called basic law of socialism—i.e. the planned nature of the socialist economy (consciously maintained proportionality); the second group consists of highly critical economists (e.g. *Wiles* 1982 and *Soós* 1983) who deny the existence of cycles, because cycles would presuppose too much regularity in socialism. Péter *Mihályi* (for short, P.M.) belongs to this latter group and has written this monograph from this point of view, (cf. Mihályi 1987, 1988a, 1988b).[2]

It is understandable that in the Stalinist regimes nodoby could mention cycle and socialism together. Only after the thaw during the sixties did the theories of socialist investment cycles (e.g. *Goldmann* 1964 and Bródy 1969) start to develop. *Bauer* (1981) summarized them and set forth his own theory (in Hungarian).[3]

*I express my indebtedness to a lot of colleagues with whom I have discussed the issues of socialist investment cycles. I acknowledge the help of A. *Bródy*, J. *Kornai*, M. *Lackó*, M. *Laki* and J. *Szabó* for their remarks on earlier versions of the review. Of course, I alone am responsible for the views expressed here.

[1] Considering China and other backward Asian socialist economies, we could use the present tense. However, our main topic is Eastern Europe, thus we shall remain with the past tense.

[2] It is unfortunate that in P.M.'s understanding of fluctuations cycles are not included. The correct solution would be something like this: within fluctuations there are cyclic and acyclic fluctuations.

[3] Bauer's first typescript (in Hungarian) became available to a small group of readers in 1977; a summary of his work appeared in 1978, both in Hungarian and English.

In 1989–1990 the Eastern-European socialist systems collapsed. P.M. is right to urge a post-collapse revision of the theories about socialism, since none of them forecasted the failure. He does not hide the fact that "Our deliberations on the investment cycle serve a more ambitious purpose: to help pave the way for a better understanding of the structure of socialist systems and the outcome of this 70 year long adventure. Retrospectively, it is clear that the causes of the collapse were more socio-political than economic. The theory of socialist investment cycles, as I see it, was misconceived precisely at this point" (p. 1).

The book contains more than 200 pages. A preface by Peter Wiles is followed by an introduction, which is also a summary. *Chapter 1* gives the general framework and *Chapter 2* presents the three schools and many "classes" of theories dealing with investment fluctuations. *Chapter 3* is devoted to the measurement of investment fluctuations. *Chapter 4* provides a historical analysis of common patterns and particularities. *Chapter 5* draws conclusions on measurement and control. *Appendix I* contains two Hungarian case studies and *Appendix II* displays the basic data. The book finishes with a long list of references, and indexes giving names and subjects.

Although I disagree with the main statements of the book, I appreciate many particular assertions. To begin with I shall record the following virtues of the book:

1. The book summarizes the literature on the socialist economy in general and investment fluctuations in particular. The author is equally at home with mathematical models, econometrics, theoretical economics, politology and modern history.

2. The book contains a data base which is as comprehensive as possible for the entire period 1950–1989.

3. P.M. is an expert on the theoretical and practical problems of statistics, and he skilfully corrects the statistical mistakes of earlier economists.

4. The author's style is clear and enjoyable and it is obvious that he likes his topic.

Rather than presenting the book in detail and in proportion, I shall concentrate on a few major issues. In *Part II* of this review I would like to demonstrate that, contrary to P.M.'s standpoint, the desriptive-explanatory theory of the socialist economy in general and (using P.M.'s expression) the investment-commitment (IC) model in particular, well characterize an important epoch of the socialist system. Finally, I would like to refute P.M.'s major claim, according to which there were no cycles in the socialist economy, although I accept with other researchers that not all fluctuations were cycles. In *Part III* I shall consider other important questions: e.g. other theories and the "style" of writing used by P.M. In *Part IV* I shall summarize the strong points of the book.

The descriptive-explanatory theory, the investment-commitment model and cycles. As I have already mentioned in the introduction, P.M. discards not only the most widespread theory of socialist investment cycles, but the underlying general theory as well.

Kornai's *general approach* is so well-known that it does not require recapitulation.

Let us turn to the *meso-theory*, i.e. IC theory. Both Bauer and Kornai emphasized that investment plans differed from the other plans in two basic aspects: a) there were fewer repetitions, and thus norms played a negligible role. b) in modern societies many investment projects take years to be completed.[4] Therefore in the socialist economies the plans had to determine not only the investment inputs of a given year (for short, *investment*) but also the total expected costs of investment projects started in the same year (for short, *start*). Before describing the control mechanism, we should also define the investment commitment (for short, *commitment*), i.e. the remaining expected costs of investment projects still in progress at the end of the same year. For any concrete project, the investment inputs to be achieved in the initial year were calculated at a very low level, so as to ensure that the total investment input did not hit the investment limit (the so-called *hooking on to the plan*). There were a couple of reasons why the gestation time in the socialist economy was of much longer duration than in the case of its capitalist counterpart.

Schematically, start and investment were controlled as the functions of commitment and foreign trade deficit (or consumption). A relatively high commitment and foreign trade deficit implied a restrained start, while a relatively high foreign trade deficit implied an enhanced investment.

Note that in a growing economy the change in commitment is equal to start minus investment. If the relative values (e.g. GDP ration) are time-invariant, then the system is in a normal state, or a generalized (non-walrasian) equilibrium.

According to Bauer, the socialist economy was not in a generalized equilibrium: the large number of requests for investment (more precisely: for start) were screened by the Centre, but the intensity of the screening periodically changed. Thus the *highest level* of the logical building was reached: namely, cycle-theory.

At this point it is appropriate to give a definition of cycle. We speak of an *economic cycle* if the most important macroindicators—e.g. the (visible) GDP ratios of investment, consumption and foreign trade deficit and the (hidden) GDP ratios of start and commitment—not only fluctuate, but return to their earlier states after regular time intervals, and this return is inevitable.[5]

According to Bauer, in the Soviet Union and Czechoslovakia during some periods the visible variables were constant and only the hidden ratios changed cyclically. In other countries both the visible and the hidden variables changed cyclically.

There are experts who do not accept all three theories. Logically it is conceivable that somebody accepts the general theory but does not accept the meso and the special theories; on the other hand, they might accept the general and the meso theories, but reject the special theory. P.M., however, rejects all three theories. Why?

Let us start with the *general theory*. P.M. accepts that "political and economic con-

[4] This feature was noted much earlier in the classical model of *Frisch* (1933).

[5] In the English language literature this is expressed by the 3 R's: recurrence, reinforcement and regularity.

trol in the socialist economies were based on centralized, non-market mechanisms" (p. 17). However, he doubts if plan and the shortage logic played the same role as the market continues to play in capitalism. According to P.M., "the proponents of the socialist investment cycles depict planners as powerful, dominating figures" (p. 20). He also calls into question Kornai's (1980) explanation of shortage: i.e. the identification of managers with their jobs (p. 172). Instead, he praises Czechoslovak and East German economists, who were silenced during the past era, but who nevertheless saw correctly. For example, the present prime minister of Bohemia, V. *Klaus*, describes the game between the lower and higher echelons of the hierarchy as a process based on a "mutual understanding of the planning ritual and on the deep dichotomy between the plan's real and formal rules" (p. 21).

What a pity that P.M. forgets about Kornai's (1980) similar observations. However, the same forgetfulness applies to Bauer's *summing up*, which represents a pair of the traditional *breakdown* of plans.

It is characteristic of P.M.'s approach that he rejects (p. 103) Kornai's credo: "The operation of the economic systems of the Eastern European socialist countries reveals some characteristic regularities. At each level of decision-making *the behaviour of the decision-maker is in a certain sense 'regular'*: definite impulses and signals lead to definite consequences." (Kornai 1982, pp. 125–126, italics in the original.)

P.M.'s critique (pp. 20–28) of the neglect of the role of the military sector, the geographical-historical circumstances and the private sector is more relevant and justifiable; however, this neglect probably stemmed from self-restraint and other simplifications.

We now turn to the *meso* (IC) theory. This is rejected by P.M., because it is based on unobserved and unobservable data. According to P.M. it is not the fault of the statistical offices that the start—commitment pairs are unrecorded, for he regards them as objectively unrecordable. Among his arguments (pp. 76–81) the impossibility of making constant price series of commitment and the elusiveness of the start play the dominant roles.

I cannot give a definitive answer, but I am to a certain extent persuaded by a fact which escaped P.M.'s attention: the start—investment distinction plays a main role in the theories of capitalist investment cycles; this can be found in the pioneering model of Frisch (1933) and the more recent "star" model of *Kydland and Prescott* (1982). The only difference is that years are replaced by quarters (due to shorter gestation times).

It is noteworthy that Bauer's explanation has several parts: a) statistical data, b) historical documents and c) earlier theories. At about the same time as the publication of Bauer's book, a couple of studies appeared which developed this theory in the directions of verbal theory, econometrics and mathematical economics. At this point it is appropriate to mention that I also took part in the process of writing several papers and half a book on this very subject.[6] We can now deal with the special issue of *cycles*. It is noteworthy that the shortage theory of Kornai (1980) and (1982) heavily relies on IC, but hardly bothers with cycles. In contrast, the title of Bauer's work (1981) contains the expression *cycle*: there is a straight road from the shortage economy to the cycles through commitment.

P.M. acknowledges that the "...discussions of cyclical fluctuations mean a critique of the existing economic mechanism." However, in my opinion he incorrectly adds that "...when partisans of the investment cycle theory insisted that there was a certain type of regularity... they acquitted economic policymakers of their responsibility" (p. 4).

P.M. could have mentioned the following mathematical observation which I have noted elsewhere (Simonovits 1991a): the mathematical models based on Bauer's cycle scheme often yield *theoretical* paths which cannot be considered as fluctuations let alone cycles. However, in *practice*, the investment hunger was so strong and so many investment projects were hooked on to the plan that the Centre had to ap-

[6] In addition to the basic Bauer (1981) book, I would emphasize the following studies using the IC approach: Kornai (1982), Lackó (1980; 1989) and *Simonovits* (1991b; 1992a).

ply strong reactions. Limiting thus the average gestation time of investments, fluctuations or cycles were generated.

We have already remarked that P.M. sees only acyclic fluctuation where Bauer spotted cycles. It is important to stress that both use the same definition of economic cycle and they relax the too strict mathematical definition: "In a more generous sense, ... the distance between successive peaks (or troughs) is more or less stable, and the amplitude (and depths) of the waves also display some uniformity" (p. 16). Unfortunately, P.M. sometimes deviates from this definition and uses the following distinction: "Cycles are predictable and [acyclic] fluctuations are not" (p. 5). This is clearly wrong, as the following example demonstrates: the path 1,0,1,1,0,1,1,1,0,... is not cyclic but can be forecasted.

The principle of unpredictability is connected with the chaos-theory (mentioned in footnote 2 on p. 2). P.M. quotes the paper I wrote (Simonovits 1991b), which itself foreshadowed subsequent studies (Simonovits 1992a; 1992b). The latter were published after the completion of the book under review. They point out that the mathematical cycle model can yield a chaotic, unpredictable path for reasonable values of the parameters.[7] Furthermore, Bauer (1981) himself referred to the irregularities of real paths.

Also, with regard to mathematical modelling, P.M. (p. 81) is wrong to acknowledge my help for a "clear formulation of [the] contradiction" between measurability of start and the significance of cost overruns.

Economy and politics. Up to now we have confined our attention to the IC cycle theory, which relies on the shortage approach. This restriction, however, is not valid for the book, since P.M. considers other theories of cycles and other underlying general theories of socialism, too. In addition, he also raises methodological issues concerning all theories of socialism.

For pedagogical reasons P.M. divides the theories of cycles into three schools: a) control theory, b) endogenous cycle theory and c) endogenous fluctuation theory (pp. 5 and 9).

a) *The control theoretical approach* relies on simple and system-invariant economic explanations. It consists of numerous theories, but not one of these is acceptable to P.M. Here we only mention *replacement cycles* (e.g. Bródy, 1972/1992) which is related to the IC theory. Bródy denies the importance of system-specific factors. In his model the instability stems from the unpleasant features of the advancement function, and it is this which P.M. criticizes.

b) *Endogenous cycle theories* are built on simple and system-specific economic explanations. We have already discussed one of the classes of this school, namely the IC theory of cycles. Another well-known class (*Winiecki* 1982) derives the *periodicity* of the economy from that of the planning system. P.M. refutes this theory with a sharp probabilistic argument (59–69).

Surprisingly, P.M. allocates Bródy and his followers (e.g. *Tarján and Tényi* 1977) to both cycle schools. The adjective *control theoretic* is also confusing: Bródy and his followers never use the keywords of the foregoing theory: namely, state and control variables; on the other hand Kornai, Lackó and myself always use them.

c) *Exogenous fluctuation theories* work with complex economic, political and other explanations. This approach, which is eclectic rather than exogenous, is accepted by P.M.

1. He adopts Wiles (1982) meta-argument, according to which socialism does not have such strict *economic regularities* as capitalism (p. 2). On the contrary, the political system enjoyed such liberty that no economic constraints were considered—"it would only halt at the cliff's edge" (Wiles, quoted by P.M, p. 100).

2. Staying with the meta-arguments, P.M. dismisses any *deterministic* description of the economy, and only accepts *stochastic* ones (p. 5). He emphasizes that even apparently regular fluctuations may arise as a result of many random events.[8]

[7] The same applies to the trade cycle model of *Hicks* (1950).

[8] It is worth mentioning that this is the theoretic basic of conservative mathematical economists (e.g. *Lucas* 1987) who reject government intervention into the working of markets. This is the dominant trend of recent economics. Paradoxically, a pioneer of the stochastic approach to business cy-

3. P.M. also rejects one of the basic assumptions of investment cycle theories, namely the *key role* of investment. He recalls the developments of the eighties, when investment indeed played a residual role: it was sharply reduced to make room for stagnating consumption in a contracting economy (p. 104). Yet when he discusses the most regular years, P.M. demonstrates that the *propagation* effects (presumed by Bauer), did not work (pp. 148–166).

4. P.M. underlines the *unreliability* of statistical data. In addition and also in contrast to *Nove*'s (1977) hypothesis of equal cheating, he argues that during the investment peaks the relative overstatement of data was much higher than during the troughs. Thus not only the absolute, but also the relative data were distorted (pp. 109–142).

Let us look at P.M.'s arguments.[9] Each of them contains some truth—we have only to judge how much. Let us consider them one by one.

1. Everybody agrees that the role of the political sphere was much larger in the socialist economy than in the capitalist economy. This does not mean, however, that the economy was a servant to politics. The "cliff's edge" hypothesis also appears in the rejected theories, although in a refined form: Kornai (1980) speaks of "putting out fires"; Bauer refers to lower and upper turning points; and Simonovits (1991b) introduces lower and upper control bounds.

2. Every sober person knows of random factors, but different people assign different roles to them. P.M.'s position is, however, sometimes extreme: ...."the Soviet famine was a classical example of a random shock, after which the system never returned to its previous growth path. Indeed, in a certain sense, it is still valid to say that in 1990 ... the combined impact of freakish weather and the catastrophic collectivisation campaign of 1933 has never been fully absorbed by the Soviet economy." (N.B. Collectivisation campaigns started in 1928, peasants slaughtered their animals in 1930, etc!) Anyway, Bauer (1981, pp. 263, 298, etc) also analyzed the stochastic disturbance of harvests on investments. Furthermore, the rigid distinction between deterministic and stochastic phenomena runs counter to a basic insight of chaos theory: deterministic systems with low degrees of freedom can also generate apparently stochastic fluctuations.

3. Bauer (1988) convincingly demonstrated that the investment cycles survived in the eighties, although alongside a diminishing investment trend. Bauer (1981) was also explicit about counter-tendencies to the typical developments.

P.M. has a valid point when he demonstrates in *Tables 2.5* and *2.6* on pp. 85 and 87 that different measures of investment dispersion provide conflicting pictures of reality.

4. P.M. is certainly right that data problems are very serious. The only problem is that, if the data are unreliable, how can he use them at all?

In my opinion, P.M.'s relation to his theoretical opponents is unbalanced. The main weakness of his critique is that it is subjective. (It is interesting that all the Hungarian participants in this multi-sided debate worked at the same institute for a long time.) Ironically, he noticed the same mistake committed by other critics. According to P.M., "...there is a good deal of justice in the harsh sentence on the investment cycle models pronounced by a Polish economist (*Podkaminer* 1989, p. 31). For him these models are not true models but rather a malicious—although politically useful—caricature of socialist planning. Nevertheless, our final judgement should be more balanced. Reality is very complex and no useful theory can encompass it all. If a theory provides a good starting point for the analysis of real problems, it is already useful. If its main conclusions are approximately fulfilled in reality, it becomes a very good theory. I think both types of investment cycle model failed on the second count but each was very successful on the first. This is already a considerable achievement" (p. 91).

He sometimes underrates his opponents by forgetting their results.[10] He is frequently

cles is R. Frisch (1933), who initiated the replacement cycles condemned by P.M.

[9] Soós (1983; 1986) already advanced many if not all the main points of P.M.

[10] In addition to the harvest—investment connection mentioned above, two more omissions are underlined: (i) before Winiecki (1982) expounded

unable to describe and evaluate the actual errors of his predecessors with due modesty. A single quotation on p. 58 from *Keynes* (1936/ 1973, p. xxi) does not absolve him: "I myself held with conviction for many years the theories which I now attack, and I am not, I think, ignorant of their strong points."

A telling example is to be found in footnote 8 on p. 182, when he exposes Bauer's failure to include the 1963 industrial overtime in his book, which contradicts his (Bauer's) theory. "At my request, Professor Bauer kindly made an effort to reconstruct the reasons for this omission, but the only answer he could give me was that the ... figure had been 'lost' somewhere in the process of editing and retyping the manuscript". (P.M. should have presented this fact with more taste, since Bauer is not a cheat, who hides unpleasant facts from himself and the reader.)

It is less implicating but a rather serious mistake that the book is not coherent. With some simplification, I suspect that P.M. was unable to drop anything which he has ever read or written on the topic. Consequently, important and unimportant materials are mixed up.

Even the title of the book is misleading. If P.M. denies the existence of socialist investment cycles, why does the word appear in the title? At least he might have ended the title with a question mark.

Two examples may suffice to illustrate such problems: (i) Why does P.M. (p. 42) list all the socialist countries which have existed if the book in its essentials is confined to Eastern Europe (including the Soviet Union)? (ii) Why does he present the data of the Soviet and Chinese famines (p. 134) when the real analysis begins in 1960?

Instead of conclusions. Until now I have dealt with P.M.'s book polemically, and rejected his main findings. This does not mean, however, that I reject the whole book.

it, Bauer (1981) convincingly refuted the cycle theory based on five-year planning (e.g. by showing that the period of the cycle is shorter than five years). (ii) the distinction between consumption— and foreign trade symmetric investment cycles made by Bauer in 1978, disproved the "conventional wisdom" of negative correlation between investment and consumption. This "conventional wisdom" was only refuted by P.M. in 1992.

P.M.'s book deserves its place in the dignified series of this famous Dutch publisher. The author has read practically all relevant studies and tried to present the weak and strong points of the various experts. Following the example of Bauer and Kornai, he has not stopped at economics but imbedded the whole discourse into a rich historical-political framework. Furthermore, he has done his best to transform the confused raw data into a tidy set of time series.

I am convinced that P.M.'s book will be an essential source for further research.

A. SIMONOVITS

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ÅSLUND, A.–LAYARD, R. (eds): *Changing the economic system in Russia*. London: Pinter Publishers. 1993. 237 p. Index.

"This is an academic book and it is candid, although it is certainly partisan"—states the introduction and the cover of the volume. Based on a conference held in June 1992 and completed in November of the same year, it gives a cross-section overview of the thinking of those who have shaped Russian reforms in their more radical phase. In fact, 10 out of the 12 contributors have been directly involved in the Gaidar experiment, and the remaining two are close associates of the leading minds of the team, *Åslund* and *Sachs*. This book is a product of the period preceding the gradual but irrevocable backtracking on systemic change, this backtracking having manifested itself since April 1992. Written by people who are right at the centre of events it should certainly be read by all those who want to gain familiarity with the aura as well as with the economics of the early Gaidar period; at that time the ever more dominant political compromise had not yet watered down the truly reformist endeavours. In the same way as re-reading the intellectual output of the January–August 1968 period in Czechoslovakia has remained an issue of lasting interest, so too is the case with "the minutes" of the Russian reform think tank. For the reader of the later period this volume provides a valuable insight into the diversity of views of the reformers and their advisers, and reproduces the flavour of the intellectual controversies of the heyday of systemic change. In the following I shall treat the debate as such and will not consider how other schools of economics or political forces might have performed under the same circumstances—which is a different story anyway.

As a general reflection, it was truly striking for this reviewer how little effort seems to have been taken to reconcile mutually exclusive policy positions. This might well be taken as a compliment to the editors in their capacity as academics, because controversy is the driving force of science. On the other hand, this state of affairs is much less reassuring from the policy-making perspective: after the phase of policy dialogue a platform is required for legislation to be operational, and this platform should set clear limits to irreconcilable concepts; such are the concepts of *Lipton-Sachs* versus *Hansson* on the rouble zone for instance.

However, let us look at the book for academic qualities only! Contributions may roughly be grouped into three categories: foreign advisors, Russian governmental officials and academic analysts. Each play a useful role in documenting the choices represented by particular options and highlighting underlying considerations, as well as reproducing a large amount of unpublished official material (which might be quite important in making value judgements of any sort). In fact, the only unanimously held view in the various approaches is the conviction that capitalism can and indeed should be "introduced" in Russia as soon as possible (pp. XIII–XIV) with speed being a dominant criterion. Yet, even in this respect, contributors from within the field of experimentation who have more empirical experience and who are more deeply-rooted in realities (e.g. *Dabrowski*, *Fyodorov* and *Vasiliev*) clearly state their concerns with regard to the actual time horizon of the transformation exercise.

In the first two chapters Åslund and Dabrowski give a detailed account of the conception of the Russian reform programme and its implementation against the background of Central European experience. They document in detail that, in terms of policy implementation and even of systemic concept—as opposed to ideological statement—there was nothing close to a shock therapy, even in the first and second quarters of 1992. Money supply grew faster than production, many prices remained regulated, inputs were centrally—or at least bureaucratically—allocated and foreign trade was controlled in a host of areas. Therefore one cannot really tell how a monetarist-inspired shock might have affected Russia, as this particular medicine has never been taken by the patient. This finding is much in line with this reviewer's previous findings, which have been elaborated elsewhere (*Csaba* 1992). While Dabrowski pinpoints rather fundamental differences in the actual workings of the Balczerowicz plan in contrast to the Gaidar policies, Åslund's insightful contribution is burdened by some paradoxes. For example, he seems to overestimate the role of academic economists, especially members of the Russian Academy of Sciences, in shaping a fairly chaotic political scene. He might be right in his severe professional criticism of the establishmentarian elder generation, but at the time close analysis shows that their influence in shaping events was close to nil from whichever aspect one cares to mention. Second, it is truly striking how his correct analysis coexists with inaccurate forecasts and controversial policy statements. To take the most important example, one wonders whether the industrialists would really pose the gravest threat to marketising reforms (p. 33) both in theory and in practice. For one thing, it is difficult to implement any project of social engineering against the factor endowments of a country, and against prevailing social strata and forces; this indeed could be taken as a truism after 70 years of state socialism. For another, either chaos or a less than enlightened populist-totalitarian (peronist) alternative are anything but excluded from the possible long-term Russian scenarios of development. Against these the evolving coalition of reformists and the military-industrial complex were obviously a superior option. Furthermore, most Western contributors tend to miss a fundamental circumstance, which is pinpointed by Sergei Vasiliev only, i.e. that the economic programme enjoyed no direct popular legitimation whatsoever until April 1993. Its feasibility was conditioned by the personal political and economic turn of the President (p. 751) as well as by the infights in his governing apparatus (p. 791). Thus it was presidential decrees and—as is obvious with the benefit of a hindsight—a *temporary ceasefire* with other branches of power which enabled Yeltsin to rule by decree for a short while. With this special privileged period gone other branches of formal and informal powers have simply returned to the scene (from which, in fact, they never defected). Thus the *conditions of implementation* have become quite different from those postulated in November 1991. Still one wonders—having read the chapters of this book—how qualified policy advisers could miss the stage of a *feasibility study*, formally required by the World Bank in order to have any projects approved. Even if the technicalities are correct this phase can hardly be avoided.

I underline this point because several contributors, most explicitly Sergei Vasiliev (pp. 79 and 82) talk about the need for a compromise with other branches of formal and informal power for this is the price to be paid for the peaceful nature of transformation. This was in fact the line followed by the international organisations, as reflected e.g. by the World Bank study on Russian reforms (IBRD, 1992 esp. pp. 69–73). This has proved to be a misjudgement. Now it seems that the curious revolution of August 1991 has remained an unfinished one. Institutions whose *raison d'étre* was to secure the old balance of power were not dismissed when the revolutionary impetus would have made it possible—for example, in the last quarter of 1991 or in the first quarter of 1992. Therefore—having survived the lethal threat—they relaunched their activities. Thus they silently but efficiently retarded and reversed radical change from April 1992 onwards. As Sergei Vasiliev points out himself on p. 81, it was a principle of political consensus among all vested interests under Brezhnev which unwittingly dug their graves in the meantime. Thus the excessive emphasis on compromise was surely a mistake in the first reform phases.

While the intricacies of power brokerage have been moving ahead at full speed, some advisers and participants in Gaidar's economic team continued to advance naive, and on occasion childish propositions; their disregard for contemporary Russian realities would have appeared odd even at the time of writing down their suggestions. *Ellam and Layard* advance the thesis that Russia has a quite effective social safety net at its disposal, and one in which problems are only caused by currency shortage and delays in payment (p. 58). Meanwhile their own data show governmental pension outlays to be only 3.9 percent of GDP against 8 percent of the OECD average, at a time when prices for basic staples, heating and housing have undergone an explosive increase. Equally, their proposition (p. 43) that workers should be laid off as soon as production falls knows no equal in the practices of OECD countries; on top of these, on p. 59 they advocate accelerated privatisation "to cope with" this problem. *Boycko and Shleifer* propose a voucher programme "for Russia" *grosso modo*. This is fairly strange, as in OECD countries first sectors, companies and other areas are targeted, their state is analysed, and then a phased timing of the operation is prepared, with cost-benefit analyses for each phase. These minor points seem to be overlooked by the two academics, as does the territorial aspect and the related redistribution of power. Not very surprisingly for Russia-watchers, territorial organs of power—who have been invited by the President to form a Constitutional Assembly at the time of writing this review—have already attained major changes in the privatisation programme, both in terms of methods/procedures and their role in managing it (Vasiliev 1993). As can be learned from the same interview with the Deputy Chairman of the State Property Management Committee, voucher privatisation is lumped with small-scale privatisation. This is described by *Chubais and Vishnevskaia* as the only right way in *Chapter 6* of the collective volume under review; in fact, it may actually account for no more than 17 percent of the assets of the Russian Federation at maximum, while the above-mentioned concessions to the regions may further diminish this share. These and other points might indicate how much the typical academic debate has been sidetracked from those Russian realities whose transformation was supposed to have been the object of the entire policy-advising exercise.

The culmination of this type of advice is of course the paper by Lipton and Sachs on the monetary system. They set out from the hardly disputable observation that "Russia began its economic reforms lacking the basic monetary arrangements necessary for a market economy" (p. 127). They propose a seven point programme to fill this gap: 1. a single monetary authority issuing roubles; 2. trade in convertible currencies with those leaving the rouble zone; 3. uniform rate of exchange; tough actions on companies delaying payments; 5. unification of cash and non-cash payments; 6. securing full independence of the Central Bank; 7. creating a banking system capable of transferring money quickly.

These are all correct proposals with impeccable records. Still, for anyone familiar with the theory of economic systems two points are conspicuously missing: 1. the need to coordinate fiscal and monetary policies. A top Russian official proposed no less than 40 percent cuts in fiscal spending for 1993 in order for stabilisation to make sense (*Fedorov* 1993); this implies that monetary policy alone is not sufficient. 2. the imminent need to institute tough bankruptcy legislation and to secure its implementation, otherwise defaults on payment would never result in exit from the market and the propositions on pp. 144–148 might not be sufficient. Both points are fairly evident, especially the second: at the time of the Stockholm conference Yeltsin tried to legislate bankruptcy laws simply by decree. This was—of course—outlawed by the Supreme Soviet in less than a fortnight. In fact, a bankruptcy law was formally legislated from 1 March 1993, to be effective from 1 May only. However, no serious cases have yet been reported (while the Central Bank has again paid out to the mutual claims of companies). In fact, these steps have been conspicuous cases demonstrating *actual independence of the Central Bank* for which Lipton and Sachs argue so forcefully on pp. 142–43. In fact they want more rather than less independence for an authority, whose records with regards to its traditions, personnel, structure, and endowments in general has made it the archenemy of any Russian marketising reform over the last 35 years or so. In the view of the US advisers, "history clearly evidences" superiority of central bank independence; possibly this does not fully cover the two European champions of price stability: the Banque de France and the Bank of England, both of which function under tight governmental control. Moreover, the Banque de France has been outperforming the Bundesbank in terms of monetary stability for over a decade (*Thieme* 1991), i.e. long before gaining independence. Interestingly, the list of commandments of the two American specialists for the statutes of the Russian central bank (p. 143) does not include the reference retained both in the French and the German bank's charter: this reference requires the two banks to act "in the framework of overall governmental policy" (see the news item and commentary in *Financial Times*, 12 May 1993). All in all, the overseas experts do not seem to be particularly familiar with continental customs and traditions, and this might be a bit of a problem. As we learn from *Izvestiia*, 19 May 1993, the split between government and central bank in Russia has become so deep that they could not sign a joint policy memorandum (i.e. a letter of intent rather than commitment), even for the new IMF credits. Yet quite apart from the facts, even in pure theory it is hard to imagine how a government can pursue a stabilisation course without having monetary policy institutionally integrated into its overall policy package.

However, this is not the whole story. Lipton and Sachs require the newly independent states to surrender their monetary sovereignty to a Russian bank, whose record in terms of monetary stability has been less than impeccable.

Those not complying should be invited politely to leave (p. 128) and the IMF should be asked to help enforce rouble withdrawal in accordance with Russian wishes and needs (p. 130) as part of the overall conditions. The reason why leaving countries would possibly disagree is lucidly elaborated in *Chapter 10* by Ardo *Hansson*. However, his contribution received little if any feedback when Lipton and Sachs finalised their chapter, and regretfully the editors have not felt the need for such feedback either. What seems a more serious flaw is in my view twofold: a) given the notorious record of *Gosbank* during the *perestroika* period, the rouble monetary authority proposal is clearly inferior both technically and in securing economic stability to the currency board solution. The idea had already been published (*Hanke and Schuler* 1991) and discussed at the time of the conference—e.g. by Hansson in this volume—but this was not considered by the authors. It does not seem a very fruitful way of conducting scientific or policy dialogue when it is constrained to restating one's own views only. Furthermore, in terms of the overall policy framework one should certainly be perplexed by the foreign advisers blatant *disregard* for Russia's historic and strategic interests as well as the well-known policy priorities of preserving a political, military and also economic community around itself in the frame of ex-Soviet borders. The historic fate of the CIS and more generally the Russian state and its immediate sphere of influence is far from being concluded, and this statement became even more valid in the first half of 1992. Consequently, one must ask how any serious analyst could advocate such a simplistic, narrow economic position which could only alienate potential allies around the government he is advising? How could it possibly be expected that new independent states be required by mandate, in the first weeks after their secession, to surrender their monetary sovereignty and to give up that unconditionally? This approach is similar to the projects of Grigorii *Yavlinskii*, which were elaborated two months before Lipton and Sachs entered the Russian scene directly. Yavlinskii was relieved of his duties because he failed to understand that the subject of reforms is Russia, not the one-time Soviet Union (Åslund and Layard, p. XII).

This and other related issues are discussed in the chapter by Ardo Hansson, which is refreshingly insightful. Contrasting the mainstream Western monetary thinking with the realities of the post-Soviet era he finds that the greatest enthusiasm for retaining the rouble zone is now found in the West (p. 164). He neatly describes why this is misplaced thinking: the creation of national sovereignty and economic stabilisation, as well as the promotion of structural adjustment, has made it imperative for newly independent states to introduce separate national currencies (pp. 166–169). He puts great emphasis both on desynchronisation of systemic change in the CIS and on the disenchanting results of Russian stabilization. His detailed description of the successful Estonian currency reform as well as his cautionary note with regard to the limited transferability of Estonian experiences to other successor states are convincing. His concluding message is that the end of the rouble zone should be taken as given, and a negotiated rather than confrontational divorce be arranged. From among the remaining external contributors, the microeconomic focus of the study of *Johnson, Kroll and Horton* on emergent Ukrainian merchant banking fits poorly into the overall concept of the book, as there is little to be generalised from what they have learned. The latter contains a lot of interesting details, like how banks can make money on negative real rates of interest if their refinancing is even more heavily subsidised by the central bank. This point sheds some light on the complexities behind the stabilisatory debate. In *Chapter 12* Peter *Boone* carries out an econometric exercise to show how beneficial the stabilisatory programme of Gaidar could have been on the Russian balance of payments, had that programme stood a chance of implementation. The doubts, which were noticeable even in November 1992, have not particularly impressed the author. Thus his forecast of steadily growing Russian exports—from 42 to 71 bn in 1992–94—also deviate slightly from the 32 bn convertible currency intakes recorded by the government (the figures of the central statistical office are even lower, but classifying the difference is beyond the scope of a book review).

The role of the Russian contributors now has to be assessed properly. Their writings are insightful and illuminating in both positive and negative senses. As an example of the former, the already several times cited contribution of Sergei Vasiliev on the socio-political and institutional aspects of Russian transformation needs to be mentioned again. His long term view, involving even stabilization cycles is quite instructive, so are his repeated warnings against an overdose of compromise with old power structures. As a less inspiring example, the contribution of Chubais and Vishnevskaia should be cited. Their description of privatisation as a single-track exercise in social engineering (having found the right single-track) is rather simplistic. Their project is strongly reminescent of old Soviet planning documents. Thus it has a large number of specific deadlines, tasks and quantitative targets, but it is not very specific about the ways of dealing with likely resistance arising from the various vested interests. I do not think anybody is really surprised that none of the deadlines have been met. On the contrary, the idea that corporatisation of all state enterprises should have been completed by the autumn of 1992 (p. 93) sounds dangerously naive: as Chubais explained in March 1993, out of the 5,600 largest companies 2,000 should have been privatised by May 1992, whereas only half of the intended small privatizations have in fact been completed 9 months later (*Transition*, Vol. 4, No. 3, p. 2). I do not consider this pace to be slow, yet the setting of unrealistic targets in terms of time and economic substance reflects an inherent inability to assess the nature of the task correctly. Disregard for technicalities and sociological factors might not be a mortal sin for pure theorists—however, for policy-makers this is not quite such an innocent feature. As the diplomat *Mozhin* notes correctly on p. 71, frequent failure to meet announced targets has seriously undermined the credibility of the reforms of the Russian government. Mozhin actually provides a lot of interesting evidence on the respective Russian and IMF positions with regard to the shape of the stabilization programme. He refutes the widely held view (e.g. *Szamuely* 1992, citing Russian sources) that balanced budgets or liberation of energy prices were imposed by the IMF team on Russians: the contrary is in fact the case (pp. 66 and 68).

Probably the most outstanding contribution of the volume is that of Boris Fyodorov. At the time of writing he was between his two Ministerships of Finance, and he seems to have dissociated himself from the predominant populism of the early Yeltsin period. In this chapter Fyodorov surveys the outcomes of the EBRD pilot privatisation project in St. Petersburg; however, in its entirety it is a strategic paper on the need to create an *organic link between foreign direct investment and privatisation* in Russia, as these constitute the two sides of the same coin. Among the many valid points he makes I find it particularly relevant to underline the following: transfer of title is the *beginning* rather than the *end* of the privatization process. *Restructuring* is the real job, which will hardly be undertaken if political privatisation continues, for the latter leads to free distribution and/or employee ownership instead of capital injections and strong managerial positions (p. 114). In fact, all that he has written could be quoted in order to show the very wide gap between governmental rhetoric regarding reforms and the truly Soviet environment that still faces enterprises. Ideally, any business executive wanting to enter the Russian market should read this analysis. Fyodorov is serious, to the point and relevant—a great plus in this volume.

Is it possible to draw a balance for such a controversial volume? Apart from some partisan statements Åslund names the overdose of gradualism as the very root of all other evils (pp. 19 and 34). In both places he seems to identify gradualism with the kind of uncoordinated policy improvisation we have been witnessing ever since reformist ideas started to influence policy-making seriously in Russia, i.e.

since May 1990. This is descriptively correct, but analytically simply wrong. In conceptual terms gradualism by definition assumes more congruence, *ex ante* policy coordination, sequencing, and policy implementation. This process has been observable in Russia, as elaborated in detail by Kloten (1993). The two cannot and indeed should not be mixed up, because this would cause serious repercussions for the entire theoretical construct and policies of transformation. In fact, many analysts in the volume under review, including Dabrowski, are quite right in arguing for shock treatment, even with the limited administrative capacities of the Russian bureaucracy. In fact, on pp. XIII–XIV the editors seem to follow the same line of reasoning. This is a different story. It may well be true that under certain conditions—like German unification or post-Soviet disintegration—gradualist propositions might become politically irrelevant or economically unfeasible. Still, the series of mutually (but poorly) coordinated, mostly improvised measures, the lack of any feasibility studies, and the disregard for the social dynamics of change (which can in fact be incorporated in formalised dynamic models) should be interpreted for what they are: prime cases of policy errors rather than attributes of any sort of gradualism. Thus whatever second thoughts one may harbour on the theoretical or policy relevance of this particular concept, Russian reforms do not provide any evidence either for or against it. If there remains anything for general economics to learn from the Russian experience it is that—similarly to 1917—the proposition that "old experiences are only of limited relevance for its future course" (p. XIII)—has not proved to be particularly helpful in transforming economic systems. This seems to be true for analytical and policy terms. This volume is certainly of great help in classifying this point.

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The editor would like to apologize for the fact that the tables were missing from the study "The Association Agreements Between the EC and Central Europe: Trade Liberalization vs Constitutional Failure?" by P. A. Messerlin in Vol. 45, Nos 1–2. This was an accidental omission and no inconvenience was intended to either the author or the readers.

Table 1

The EC-Hungary Association Agreement: main provisions on trade in goods

	EC MFN tariffs or levies						NTB dismantlement					
	1992	1993	1994	1995	1996	1997	1992	1993	1994	1995	1996	1997
							AGRICULTURAL PRODUCTS					
Non-processed agricultural products												
General provision							elimination of "specific" QRs (R.3420/83) in 1992					
Annex VIIIa[a]	50%						quotas/ceilings increased by ≈35% (1992–96)					
Annex VIIIb	tariff reductions on an item by item basis						for some items, minimum import prices					
Annex Xa[a]	75%						[b]	9.1	8.3	7.7	7.1	
Annex Xb[c]	80%	60%	40%				quotas/ceilings increased by ≈35% (1992–96)					
Annex Xc	75%	50%					quotas/ceilings increased by ≈35% (1992–96)					
Processed agricultural products (Protocol)												
	see text						quotas/ceilings increased by ≈35% (1992–96)					
							INDUSTRIAL PRODUCTS					
General provision[d]	elim.											
Exceptions												
Annex I	ruled by provisions for agricultural products											
Annex IIa[e]	50	elim.										
Annex IIb[e]	80	60	40	20	elim.							
Annex III[e]	suspension of tariffs						within increased quotas or tariff ceilings					
" and[e]	90	80	70	60	50	elim.	for quantities in excess of quotas/ceilings					
Special protocols												
Coal			50		elim.		elim. by 1992, except for Germany & Spain (1994)					
Steel	80	60	40	20	10	elim.	elim. on the date of entry into force					
Textiles	71		57	43	29	14	final provisions not available					

Source: The EC-Hungary Association Agreement (1992).

Notes: [a]Figures give the level of remaining duties (within quotas) as a percentage of the initial level.

[b]Annual rates of increase of the global quota on meat.

[c]Figures give the level of remaining duties or levies (within quotas) as a percentage of the initial level.

[d]elim.: elimination.

[e]Figures give the level of remaining tariffs as a percentage of the initial level.

Table 2

Trade patterns of CEEC exports to other CEECs and to OECD countries, 1985–1989

SITC 2	Products	Exports to other CEECs[a] by						Exports to OECD countries by					
		BUL	CSFR	HUN	POL	ROM	USSR	BUL	CSFR	HUN	POL	ROM	USSR
	Industries with shares superior to 3 percent of the total corresponding trade, %												
1	Meat and meat preparations			5.8						10.4	5.7		
3	Fish										3.4		
4	Cereals			5.4									
5	Vegetables & fruits			5.4				5.7		5.1	4.6		
11	Beverages							3.0					
12	Tobacco							5.3					
24	Cork and wood								6.7		3.3		6.7
25	Pulp & paper								3.1				
32	Coal & coke				12.0				4.4		15.3		3.0
33	Petroleum						36.6	16.9	6.7	7.7		31.4	48.3
34	Gas, natural						12.6						12.5
35	Electric current						4.9						
51	Organic chemicals							5.0	5.0	5.4			
52	Inorganic chemicals												3.1
54	Pharmaceuticals			5.2	7.2								
56	Fertilizers, manuf.											3.8	
58	Artif. resins, plastics								3.3				
65	Textile yarn, fabrics								7.1	3.4			
66	Non-metal. mineral manuf.		3.1						5.2				
67	Iron & steel		5.5		3.9		4.4	11.1	10.5	5.1	4.2	7.4	
68	Non-ferrous metals						3.6			3.5	6.4	4.8	6.5
69	Manufactures of metal				3.1								
71	Power generating machinery		4.1	17.3	23.4		6.4						
72	Machinery specialized		18.5	11.1	8.8		4.6		3.3				
73	Metalworking machinery		5.0	18.7	16.3		6.3						
74	General industrial machinery		6.8										
77	Electrical machinery		4.1							4.2			
78	Road vehicles		12.4						3.2				

Table 2 *(continued)*

Trade patterns of CEEC exports to other CEECs and to OECD countries, 1985–1989

SITC 2	Products	Exports to other CEECs[a] by						Exports to OECD countries by					
		BUL	CSFR	HUN	POL	ROM	USSR	BUL	CSFR	HUN	POL	ROM	USSR
79	Other transport equipment		6.2										
82	Furniture											9.3	
84	Apparel		3.8	4.0	4.4			8.1	4.6	10.2	7.5	13.1	
85	Footwear		3.8										
89	Miscel. manuf. articles				3.2				3.5	3.5	3.5		
	Total (from SITC 1 to 66)		3.1	21.9	19.2		54.1	35.9	41.5	31.9	32.3	35.2	73.6
	Total (from SITC 69 to 79)		57.2	47.1	51.5		17.3	0.0	6.6	4.2	0.0	0.0	0.0
	Total		73.4	73.0	82.3		79.4	55.0	66.7	58.4	53.9	69.9	80.0
	Trade shares of the "four sectors"[b]												
	Agriculture		0.8	19.0	3.9		0.3	14.0	7.1	21.2	16.1	3.9	0.3
	Textiles & apparel		7.3	6.4	5.9		2.4	12.3	12.8	14.5	10.0	17.1	1.7
	Chemicals		3.4	1.5	1.7		5.4	9.4	10.0	9.9	5.3	7.5	5.4
	Iron & steel		5.5	1.4	3.9		4.4	11.1	10.5	5.1	4.2	7.4	1.5
	Total		17.0	28.3	15.4		12.6	46.7	40.4	50.7	35.7	35.9	9.0

Sources: OECD, Foreign Trade by Commodities, various files. COMTRADE database. Author's computations.

Notes: [a] No data are available for Bulgaria and Romania. For the CSFR, computations are based on exports to the other CEECs. For Hungary and Poland, computations are based on exports to the USSR (1985–87). For the USSR, computations are based on the Soviet exports to the PITs (1985–87).

[b] Agriculture is defined by SITCs 0 + 1 + 2 + 4 + 5 + 6 + 8 + 22, Textiles and apparel by SITCs 26 + 65 + 83 + 84, Chemicals by SITCs 51 + 52 + 53 + 56 + 57 + 58, Iron and steel by SITCs 67.

Table 3

EC protection in agriculture, 1985–1990

Agricultural products	Nominal assistance coeff[a]	PIT export share in EC ag. imports[b]			
		PITs	CSFR	HUN	POL
	Year 1986				
Meat	63.0	20.2	2.8	9.5	8.0
Dairy	57.5	1.2	1.0	0.2	0.0
Grain	45.5	2.6	0.4	2.1	0.1
Sugar	107.0	3.6	0.4	1.2	2.0
Oilseeds	75.0	3.0	0.0	0.8	2.2
All ag. products		5.0	0.6	2.1	2.3
	Year 1988				
Meat	125.3	20.6	2.5	10.2	7.9
Dairy	74.0	1.5	0.9	0.5	0.1
Grain	81.5	2.2	0.3	1.7	0.1
Sugar	176.0	3.1	0.5	0.9	1.7
Oilseeds	110.0	2.1	0.0	0.7	1.4
All ag. products		5.0	0.6	2.2	2.2
	Year 1990[c]				
Meat	104.7	22.5	2.6	11.2	8.6
Dairy	99.5	9.9	4.4	1.1	4.4
Grain	87.5	2.5	0.4	2.0	0.1
Sugar	113.0	3.5	0.5	1.2	1.7
Oilseeds	184.0	3.5	0.1	0.8	2.6
All ag. products		6.4	0.8	2.7	2.9

Source: OECD, Monitoring and Outlook (1991). OECD, Foreign Trade by Commodity. Author's computations.

Notes: [a] Ad valorem tariff equivalents, in percent.

[b] Meat: SITC 00 and 01; Dairy: SITC 2; Grain: SITC 4; Sugar: SITC 06; Oilseeds: SITC 22; All ag. products: SITC 00, 01, 02, 04, 05, 06, 08 and 22.

[c] 1990 data for NACs and 1989 data for trade flows.

Table 4

EC tariff concessions granted by the EC-Hungary Association Agreement, 1992–1997

ISIC	Sectors	Total number of items[a]	MFN tariffs		Combined MFN-GSP tariff rates[b]	Agriculture[c]		Industrial products[c]			
			number of items	avg tariff rates		number of items	avg tariff rates	total number items	non-lib items[d]	non-lib avg rates	relat. avg[e]
100	Agriculture	627	577	9.3	8.9	494	10.8	83	10.8	0.8	0.09
200	Mining	112	110	0.5	...			110	10.0	2.1	4.64
311	Food products	757	401	16.8	13.0	394	16.9	7	42.9	6.0	0.36
312	Other food products	141	82	9.0	...	72	9	10	100.0	9.3	1.03
313	Beverages	72	52	17.5	...	52	17.5				
314	Tobacco	10	10	7.4	...	10	7.4				
321	Textiles	1081	1081	9.9	9.2	2	4.5	1079	16.6	8.4	0.85
322	Apparel	219	219	12.3	11.5			219	4.6	7.9	0.64
323	Leather products	102	102	4.7	3.3			102	50.0	5.8	1.24
324	Footwear	68	68	10.9	...			68	83.8	12.0	1.10
331	Wood products	124	124	5.3	...			124	6.5	10.0	1.87
332	Furniture	27	27	6.0	...			27	11.1	5.6	0.93
341	Paper products	196	196	7.6	...			196	0.0		
342	Printing	43	43	6.1	...			43	0.0		
351	Industrial chemicals	881	881	7.1	4.7	6	5.8	875	9.6	8.1	1.14
352	Other chemicals	375	361	6.2	4.1	16	2.9	345	3.8	10.5	1.70
353	Petroleum refined	40	40	4.6	...			40	0.0		
354	Misc. petrol. & coal	15	13	2.6	...			13	0.0		
355	Rubber products	80	80	5.9	...			80	31.3	10.3	1.76
356	Plastic products	139	139	8.9	...			139	6.5	11.9	1.33
361	Pottery & china	24	24	8.4	...			24	33.3	9.8	1.16
362	Glass products	132	131	8.3	...			131	54.2	9.4	1.14
369	Other nonmetal minerals	121	121	4.5	...			121	6.6	8.8	1.94
371	Iron and steel	469	469	4.8	4.8			469	20.5	5.5	1.14
372	Nonferrous metals	262	262	4.6	...			262	32.1	6.2	1.35
381	Metal products	524	524	5.8	...			524	13.7	8.9	1.53
382	Nonelectrical machinery	924	924	4.1	...			924	0.1	9.0	2.17

Table 4 *(continued)*

EC tariff concessions granted by the EC-Hungary Association Agreement, 1992–1997

ISIC	Sectors	Total number of items[a]	MFN tariffs		Combined MFN-GSP tariff rates[b]	Agriculture[c]		Industrial products[c]			
			number of items	avg tariff rates		number of items	avg tariff rates	total number items	non-lib items[d]	non-lib avg rates	relat. avg[e]
383	Electrical machinery	501	501	5.8	...			501	15.8	11.2	1.93
384	Transport equipment	342	342	6.1	...			342	3.8	10.7	1.75
385	Scientific equipment	352	352	8.3	...			352	2.3	5.8	0.70
390	Other manufacturing	263	263	5.5	...	5	0.0	258	12.0	8.0	1.44
	Whole EC economy	9023	8519	7.8	6.1	1051		7468	12.6	8.3	1.06
	Recapitulation by annex										
	annex I								185	8.3	
	annex IIa								98	4.5	
	annex IIb								10	7.7	
	annex III								640	8.9	
	annex VII								20	12.3	

Source: The EC-Hungary Association Agreement (1992). Author's computations.

Notes: [a] Total number of items in the trade EC Combined Nomenclature.

[b] Combined MFN-GSP rates have been computed only for the major PIT export sectors and the whole EC economy.

[c] According to the definition of the Association Agreement.

[d] Number of items in Annexes (no immediate liberalization) as a percentage of all industrial items.

[e] Average tariff rates for items under delayed tariff cuts with respect to the average tariff of the concerned sector. Textile and apparel products are considered under the "general provision".

Table 5:1

The EC MFA VERs imposed on CEEC exports, 1985–1990

	1985	1986	1987	1988	1989	1990	Regional limits[a]	Compound growth rates
Number of categories where CEEC exports are under VERs								
Bulgaria	25	25	12	11	11	11	1	−18.56
CSFR	50	50	41	40	40	40	3	−5.43
Hungary	37	37	29	29	29	29	2	−5.91
Poland	34	34	28	28	28	28	5	−4.74
Romania	39	39	32	32	32	32	6	−4.83
Total number of categories[b]	84	84	84	99	99	99		
Trade coverage ratios, in %[c]								
Bulgaria	38.0	40.6	45.7	41.6	36.0	n.a.		−1.34
CSFR	61.9	61.5	64.7	59.6	57.9	n.a.		−1.66
Hungary	52.8	51.5	47.2	43.7	44.7	n.a.		−4.08
Poland	53.5	54.6	52.1	44.1	41.8	n.a.		−5.98
Romania	61.5	61.5	63.5	57.9	55.2	n.a.		−2.67
Developing countries[d]	39.1	38.9	36.2	n.a.	n.a.	n.a.		−3.78

Sources: World Bank MFA Database (for 1985–89); EC Official Journal (for 1990). OECD, Foreign Trade by Commodities, various issues. Author's computations.

Notes: [a] Number of categories under specific quotas imposed by EC Member States.

[b] Total number of categories in the whole EC MFA system.

[c] CEEC exports to the EC under EC MFA VERs divided by total CEEC exports of textiles and apparel (SITC 26, 65, 83 and 84) to the EC.

[d] Source: Erzan, Goto and Holmes (1990).

Table 5:2

EC MFA quotas and PIT export performances, 1989–1992

	MFA "import" quotas[a]			PIT quota shares[b]		MFA "OPT" quotas[c]		Utilization rates[e]
	old 1990	1990 1991	1992	1989	1992	tons 1992	%[d] 1992	1990/89
All MFA categories								
CSFR	36181	39246	70573	3.2	6.2	13996	16.5	105.2
f		8.5	79.8					
Hungary	24699	26811	35804	3.0	3.7	26383	42.4	108.4
f		8.6	33.5					
Poland	21305	29838	50847	2.9	5.5	39936	44.0	84.1
f		40.1	70.4					
MFA categories fully utilized in 1989								
CSFR	10336	11536	26343	2.2	5.0	11384	30.2	102.2
f		11.6	128.4					
Hungary	2205	3255	6868	1.0	3.0	22678	76.8	73.9
f		47.6	111.0					
Poland	2281	3541	7623	1.1	3.5	20297	72.7	91.4
f		55.2	115.3					

Sources: World Bank MFA Database; EC Official Journal; Eurostat. Author's computations.

Notes: [a]Quotas (excluding OPT) in "old" 1990 correspond to the MFA-IV regime.

[b]Shares of quotas granted to the PIT country as a % of total EC quotas.

[c]OPT: outward processing traffic.

[d]"OPT" quotas as a % of total ("import" plus "OPT") quotas.

[e]Utilization rates for 1990 as a % of utilization rates in 1989 (excluding categories 14 and 15).

[f]Rates of growth, in percent.

Table 6

The EC steel quotas under the arrangements, 1989–1991

Years[a]	CSFR con.[b]	CSFR lib.[c]	Hungary con.[b]	Hungary lib.[c]	Poland con.[b]	Poland lib.[c]	Total PITs	Other CEECs[d]	Grand Total	Imports	Utiliz. rates[e]
Export program imposed by Germany											
1989	245610	222274	60889	94433	133409	153393	910009	342259	1252268	890000	71.1
1990	245610	229148	60889	97354	133409	158137	924548	346347	1270895	998000	78.5
1991	359000	236235	89000	100365	195000	163028	1142628	474470	1617098	1587000	98.1
Export program imposed by Benelux (Belgium, Luxembourg, Netherlands)											
1989	39400	1623	7650	1623	13950	1623	65869	50746	116615	182000	156.1
1990	46670	1673	8825	1673	16524	1673	77039	59613	136651	178000	130.3
1991	46670	1725	8825	1725	16524	1725	76924	59716	136640	123000	90.0
Export program imposed by Italy											
1989	116802	40716	111240	0	15494	14393	298645	178117	476761	815000	170.9
1990	138352	41975	128623	0	36492	14838	360280	205442	565722	1117000	197.4
1991	138352	43273	128623	0	16492	15297	342037	206067	548104	1007000	183.7
Export program imposed by the other EC Member States											
1989	0	260317	0	117659	0	127895	505870	224694	730564	644000	88.2
1990	0	268368	0	121298	0	131850	521516	231643	753158	355000	47.1
1991	0	276668	0	125049	0	135928	537645	238807	776452	409000	52.7
Export program imposed by the whole European Community											
1989	401812	524929	179779	213715	162853	297304	1780393	795816	2576209	2531000	98.2
1990	430632	541164	198337	220325	186425	306499	1883382	843044	2726427	2648000	97.1
1991	544022	557901	226448	227139	227746	315978	2099234	979060	3078294	3126000	101.5

Source: EC Official Journal (various years) and interviews. Author's computations.

Notes: [a]Figures for "liberalized" steel in 1989 and 1990 are estimated.

[b]Con.: PIT export program under steel quotas.

[c]Lib.: PIT export program of "liberalized" steel.

[d]Export program (of quota and "liberalized" steel) for Bulgaria, Romania and the USSR (for the USSR, liberalized steel is not included). Quotas on GDR steel were eliminated in 1991.

[e]Imports as a percentage of Grand Total.

Table 7

The EC antidumping actions against the CEEC exports: A summary by major industries and by CEEC, 1980–1991

Countries Goods	Cases (number)	Preliminary actions: margins of dumping (avg)	Preliminary actions: ad valorem duties (avg)	Preliminary actions: other measures[a] (number)	Definitive actions: margins of dumping (avg)	Definitive actions: restrictive measures (number)	Definitive actions: restrictiveness rate[b] %	Definitive actions: ad valor. duties or equival.[c] (avg)
Global figures								
All cases against CEECs	105	67.3	26.5	8	46.0	74	71.2	19.8
All other cases[d]	236	30.3	17.4	45	27.8	155	66.8	[e]
Cases against CEEC exports, by CEEC								
Bulgaria	6			0	50.4	3	50.0	33.0
CSFR	25	46.6	17.1	2	48.9	19	76.0	22.6
Hungary	16	147.0	51.0	0	33.3	9	56.3	19.1
Poland	15	41.3	23.8	1	36.2	11	73.3	16.1
Romania	21	59.9	32.8	0	42.0	16	76.2	19.7
USSR	22	83.8	26.0	5	60.7	16	76.2	14.4
Cases against CEEC exports, by industry								
Wood products	7			0	17.6	1	14.3	12.0
Industrial chemicals	50	61.3	25.3	4	43.8	40	81.6	16.7
Glass products	9			0	36.9	9	100.0	27.4
Iron and steel[f]	6	54.6	25.7	0	46.9	5	83.3	22.5
Nonelectrical machinery	7	204.0	33.0	0	68.0	6	85.7	19.2

Sources: Messerlin (1992).

Notes: [a]Number of specific duties imposed in preliminary actions.

[b]Restrictive outcomes as a percentage of all known outcomes.

[c]See note for the definition of the methods used for computing ad valorem equivalents.

[d]All cases initiated between 1980 and 1989, excluding cases against exports from CEECs, Eastern Germany, the People's Republic of China and North Korea.

[e]Partial information suggests an average estimate of 18.3 percent.

[f]Including cases against CEEC exports of tubes and pipes (non-ECSC steel).

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