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SOME THOUGHTS ABOUT THE "WORLD RULED BY MONEY"—THE INCREASED ROLE OF THE FINANCIAL SYSTEM

P. PETE

Explosive developments experienced in the financial sector in the past twenty years have raised worries in the eyes of many observers. Opposing opinions in the heated debate, however, are burdened with prejudice and misunderstandings. This study attributes the fast development of financial institutions and their increasing significance to the development of information technology. Moreover, it gives a critical overview of the arguments which claim that the financial sector is oversized and parasitic.[1]

Introduction

"The most important distinguishing feature of the financial superstructure, that stands above the economy and society of our globe—and which we call ≪the money world≫—is that it has largely broken out of the world where regular goods and services are traded and where those things are produced that serve the necessities of life for the people at large. At the same time, in the last quarter of this century economic activities—meaning: activities that aim to reproduce and sustain human beings and their natural and cultural environment—almost everywhere and in almost all aspects have been subordinated to the rule of the monetary world." (*Lányi* 1996, p. 5)

"Watching evening business news on NBC or CNN one has the impression that the economy merely consists of Dow Jones and other indices jumping up and down and electronically running around the world's stock exchanges from New York to Frankfurt, from London to Tokyo. Production, technology consumption and similar ≪insignificant≫ issues are hardly talked about; what makes the news is if a currency is attacked or if there is a big scandal in the money markets.

An oversized, parasitic financial superstructure dominates the economy. Production of goods and services has been pushed to the backstage, where capital moves quietly but swiftly searching for cheap labour. Societies have learnt to tackle by inflation, unemployment and long lasting recessions instead of achieving real economic growth." (*Augusztinovics* 1996, pp. 317–318)

In recent years several highly respected economists have written similar sentences expressing their worries about the radically increasing role of the financial

[1] An earlier version of this study appeared in *Laki, Pete and Vince* (1999). I am grateful to all of those who gave their comments and advice for this version.

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sector—banks, financial markets and their instruments—and these worries are, of course, not restricted to Hungary alone. True enough, growing hostility felt by many people against the rapid growth of the financial sector is attested by the tone of journalists' articles. However, there is much more in the quotations above than that. There is a global worry, a general dissatisfaction with the main direction of the developments experienced in the market economy as such. Those, however, who specialize in banking and finance matters find this vision of a degenerating world and world economy exaggerated and they attribute the fears against the financial sector to misunderstandings over its real role and activities. What is more, they point to the benefits—i.e. the increases in efficiency as well as savings coming out of the new opportunities, new methods for handling risks and reductions in transaction costs—provided by the new developments in the financial markets.[2] It seems that on this quite significant subject a thorough and correct discussion is developing in professional economic journals.[3] This study, a loose set of my thoughts related to the subject rather than a report on rigorous scientific research, is to be considered as my contribution to this debate.

Economic analysis or criticism of the social system?

The decisive question of the discussion at this phase, as I see it, is not whether the truly revolutionary developments that have happened in the past two, two and a half decades in the financial sectors of the world economy can be regarded as beneficial or harmful. More important is that we find out what led to the emergence of these structures and to this kind of development. What lays behind positions taken in the debate in most of the cases has not much to do with narrow opinions concerning money or the monetary system—rather, they represent criticism against the general workings of modern society and, probably, the issue has always been treated this way.[4] Given this, it is not likely that finding the true reasons and procedures underpinning this development will change anyone's value judgements

[2] "...the operation of these—seemingly oversize and self-contained—markets generally reduces the social costs of production, technology, construction and consumption. Anyone who wishes to restrain the emerging institutions or their operating mechanisms must remember that, apart from the expected favourable consequences, the damage done to these functions results in higher social costs and a larger deadweight loss." (*Csontos, Király and László* 1997–98, pp. 14–15)

"The costs of implementing financial strategies for institutions using derivatives can be a tenth or twentieth of the cost of using underlying cash-market securities. Looking to the future with such costs savings, we are not going back. Derivatives are a permanent part of the main stream global financial system." (*Merton* 1995, p. 6)

[3] Ms. Kamilla Lányi has made a considerable contribution in directing the attention of the Hungarian economic literature to the potential consequences of this fast extension of the financial sector.

[4] For more on this see Csontos, Király and László 1997–98, pp. 14–15.

towards the sector. Still, the choice of social values and the economic analysis are to be strictly separated. In general, values (i.e. tastes and preferences) are not subjects for economic analysis. Statements such as this: "instead of investing into foreign exchange swaps the society should invest into housing blocks as homes are useful while currency swaps are not" have no meaning for economic analysis. Those who invested into foreign exchange swaps supposedly thought different, as they most probably had the option of investing into homes but they still did otherwise. Proving that the financial sector is a parasite, it is oversized or superfluous would require some general criteria reaching beyond subjective taste. A general criteria like that can be the Pareto efficiency, which is used quite often in economic analysis.

Most of the hostile feelings expressed against money and the financial sector are simply cover-ups for the disapproval of capitalism or the market system in general. The financial system is, no doubt, a product of a market economy based on free exchange. It is not a coincidence that the centrally planned economy did not need real banks, and not only blocked but punished the spontaneous development of the financial sector. It is still a misunderstanding leading to confusion if we identify the free market economy with one of its institutions—i.e. with the one that makes free exchange more efficient: the monetary-financial system. One may have a preference towards a social system whose members follow some assumed collective values and utilize existing resources through collective decision-making, rather than a system based on individual calculation. One can also prefer a system of income distribution along the lines of some assumed social justice and refuse "merciless competition and selfish search for profit". However, the choice of values offered above does not require that one symbolizes the negative features of the refuted values with the concept of money or with the activities of the financial sector. The criticism of the social system smuggled in behind the issue does not help scientific research into the true nature and role of the financial system in the modern economy.

Of course, it is not being stated here that this advancement of the financial sector experienced in recent decades does not have social consequences. Clearly, it does. It would even be naïve to deny that its positions are strengthening inside the economy and that economic power is being redistributed towards the financial sector (although the reshuffling of economic power is difficult to measure in exact scientific terms). However, various sectors of the economy have always been growing at different rates; thus, at times, some have dominated the whole structure while others have lagged behind. This kind of unevenness can be considered as a regular feature of economic development. Moreover, the faster growth of the financial sector is not at all new; economic research has shown a positive relationship between economic growth in general, and certain monetary and financial indicators in particular. Empirical findings have also established that, in the long run, expansion of the financial sector has been much faster than that of the rest of the economy, even when compared with developments in the past.

Simon Kusnets' famous cross-country empirical research based on 57 countries' data from 1958 dealing with the relationship between the level of GDP and the weight of different sectors in the whole economy (*Kuznets* 1971), showed that, moving from the low income countries towards the high income ones, the contribution of the banking and insurance sectors to national income was growing radically. (Back in 1958 there was not even a mention of global financial markets or derivative instruments.) The results of investigations published in the 1950s and 1960s by R. Goldsmith showed that in the period ranging from the middle of the last century to the middle of this century the share of financial wealth was growing fast in the total wealth, and the rate of financial wealth to GDP also increased. (*Goldsmith* 1958, 1969) Similar findings—i.e. an increasing share of certain monetary and financial aggregates to GDP as economies grew—were reported by *Mc.Kinnon* (1973).[5] Hostile feelings against the financial sector were probably strengthened by the fact that these developments, experienced in the past, were seen to be accelerating rapidly and the speed of these developments gave many observers the impression that the development was at someone else's expense. This was particularly true for those who felt left out of this development.

It is quite natural that representatives of a fast-growing economic sector would see their positions improving in the social structure as well. If the system of financial institutions of the modern economy is truly "oversized", perhaps even "parasitic", then improvement in the economic-social positions of its representatives can also rightly be criticized. These statements, however, first have to be proved. A procedure that recognizes the growing influence and power of the financial elite with some critical overtones, and uses this as proof of the statement that the financial sector is oversized or superfluous (without even examining the reasons that led to the growth of the sector), is one which does not meet the requirements of scientific analysis.

I do not consider the unprecedented developments in financial markets and transactions, as well as in the institutions that carry them out, as a degeneration in the economic system. Rather, I see the whole process as being a direct result of changes in science and information-technology. Instead of developing panic and fear against the strengthening positions of the financial world we should take a look at the most significant results science and technology has produced in recent decades; perhaps even better, we should single out which field of technological changes has produced the most striking results.

Let me illustrate my point with a well known example. We all know how much the industrial revolution was assisted by the invention of the steam engine. This kind of mechanical source for supplying power, that took over the role of animals or man, was truly a precondition for a large scale development of industry

[5]Since then there have been some promising experiments which have tried to explain those empirical observations with formal theoretical models. See, for example, *Townsend* (1983).

based on machines. This development changed the structure of the economy, put new industrial sectors ahead of traditional agricultural activities, and made their representatives—the bourgeoisie—victorious against traditional landed aristocracy.

Modern economic theory holds that the institution of money, as well as financial intermediation, financial markets and their transactions and instruments (just like other numerous institutions developed by the market economy) are all invented to solve problems stemming from lack or scarcity of information, its uncertainty and its speciality as an economic good. Even the role financial institutions fulfil in reducing transaction costs is connected to gathering and processing information because most (if not all) transaction costs are related to information about goods, assets and their qualities, market opportunities and so on.

If all market players had all information available at no cost and we could also do away with uncertainty,[6] then the market economy would not need money at all, neither would it need financial intermediation, banks, money markets and instruments.[7] Quoting Brunner and Meltzer on this issue: "Markets do not operate without costs. The execution of transactions requires an allocation of scarce resources. Acquiring information about market opportunities also uses valuable resources. In the presence of information and transaction costs, people face an optimizing problem. To solve the optimizing problem, they search for optimal arrangements for the execution of exchanges. An optimal choice of arrangements lowers uncertainty and transaction costs to the minimum attainable. Financial intermediaries and the role of money as a medium of exchange emerge from the search process." (*Brunner and Meltzer* 1993, p. 66.) With all this in mind, the rapid development of the financial sector is not a surprise—rather, it would have been strange if it had not happened. This is the sector of a modern economy that specializes in handling and processing economic information and solving the problems connected with it. A revolution in the fields of handling, processing and transmitting information necessarily puts financial activities into the centre of economic development pushing it to a fast track. No doubt, there might be social consequences of this fast development which hurts the tastes or social values held by many people. However, one should not erroneously identify technological development with their social consequences—a mistake committed by the machine breakers who mistakenly blamed the harsh social conditions of the industrial revolution on the machines themselves.

In the rest of this study the social aspects which have been smuggled in behind criticism against new developments in the financial sector will not be dealt with at

[6] However, this assumption is quite unrealistic, although we should remember that most traditional economic models resort to it. A large proportion of the most significant results provided by modern economic theory came as consequences of breaking with those types of simplifying abstraction.

[7] For a seminal model analyzing the relationship between transactions costs of exchanges and the institution of money see *Alchian* (1977).

all. Such a task would go much beyond my competence. I will concentrate on two issues often raised in the current debate. These are: 1. Is the financial sector really oversized and self-centered? and 2. Is it really parasitic, developing at the expense of others?

Getting oversized and losing touch with the real sectors

What is it that makes many people believe that the financial sector has become too large? Why is the belief held that we do not really need so many transactions, so many institutions? Nobody questions that the sector does have a very important role in the modern market economy. To produce goods and services we need capital accumulation. Most of the savings that are to finance capital accumulation are done in other sectors, not where they are invested. Someone has to mediate between savers and investors and the financial sector is the most suitable institution to fulfil that role. Almost everybody would agree with that. This is exactly the point that those warning against the self-centred, oversized finance industry would stress, namely: that the finance sector does not do that any more—rather, it offers various bets for guessing the future values of certain numbers (like BUX, DAX or Down Jones indices); most of these numbers have hardly any relationship with the real economy.

We should notice, however, that if one defines the "very essence" of economic activity as production and distribution of those goods and services that serve as necessities of life (as the authors we quoted at the beginning of this study do) then one mixes value judgements with economic analysis (which, as stated above, causes troubles at the philosophical level). Even inside economic analysis this view implicitly and without any justification automatically assumes priority to *flow* economic phenomena (i.e. production and consumption) against the *stock* relationships (i.e. portfolio adjustments) in economic life. Flow production activities would, of course, require a prior accumulation of capital, but this view would consider wealth and capital stock only as a resource used to produce goods and services. Consumer wealth (a family home for example) would be looked upon as something that directly provides flow consumption services (evidently, we are living in the house) while elements of productive capital would be regarded as necessary tools for the production of things necessary for living. This implies that, with respect to the problem of how to channel accumulated saving towards investments, new—that is, flow—savings and investments—enjoy priority above restructuring of old, previously accumulated wealth. Therefore, in this view, the whole world of trading in elements of accumulated wealth or trading in asset portfolios is assigned secondary importance. Even those authors who warn against the overly powerful financial sector would not deem trading in assets to be so superfluous. As with changes in the economic structure, new owners of capital assets perhaps can utilize those better; therefore asset traders, somehow like real estate brokers, do provide some useful real services. But even these types of transactions are useful only because they are related to flow production activities. They are useful if they improve the conditions of production but they do not make any sense, or are even superfluous, if they are not related directly to production. Moreover, we explicitly or implicitly assign priority to the flow world in economic activities and accumulated capital, and wealth is only something assisting production, then those (mainly financial) transactions carried out in the asset markets (and which would only change ownership of assets without having any impact on the size or usage of real capital) would be called self-oriented or superfluous. This is because they certainly do not serve directly any production goals of the real sector. If these transactions are motivated by changes in prices of assets, *horribile dictu*, they are carried out in order to search for profit opportunities provided by expected future price changes; these actions certainly do cause harm, because this is parasitic behaviour better referred to as speculation. True enough, the past two decades have witnessed just these forms of transaction growing fastest on asset markets. Furthermore, both in terms of the number of transactions and their values, they now dwarf "traditional" transactions (i.e. those directly related to commodity trade or for financing production activities). On the basis of this one can state the negative verdict: the financial world has lost touch with the real world. It has broken away from the sphere of economic activities which make sense for humankind—it has become self-centered and senseless. Anyway, whose standard of living would improve if the same government bond was exchanged a hundred times a month at different prices?

People who mix social value judgements with economics, but who have only a vague or total absence of knowledge about how financial markets work and what role certain transactions fulfil in the economic process, can easily find the argument provided above attractive. There is not space here to give a detailed account of these issues. Fortunately, there are some excellent volumes dealing with these questions which have even been translated into Hungarian.[8] It is still worth remind the reader here that this kind of bleak, gloomy picture of a decadent economy is not at all new. The latter view suggests the people mistakenly assign great significance to the prices (exchange values) of goods and organise their economic and social efforts and activities according to those instead of concentrating on the really important aspect, the "real" source of wealth: namely, value in use. Moreover, this distortion of the capitalist market economy is claimed to be due to the mode of production and the ownership system. In fact, these arguments were considered to be integral parts of the ruling ideology and were taught at every college in Hungary (and elsewhere). Yes, of these are the ideas of Karl Marx. He was the one who saw a contradiction in the separation of value (i.e. value in exchange) and value in use as being characteristic of market economies. It is also a characteristic of societies where

[8] For an exhaustive discussion of those see *Kohn* (1998).

people are separated by the division of labour but are connected by exchange, by the market. It is then assumed that this feature would cease to exist if one abandons private ownership of productive capital and eliminates the market economy.

More than thirty years after it was openly admitted that the centrally planned economy cannot work[9] and about ten years after the collapse of socialism, most probably there are only very few who believe that a centrally planned programme of society level production and consumption based solely on "value in use" is possible (or rather, it can be done only in a way that would not satisfy anyone). L. Mises and F. A. Hayek had serious doubts much earlier than that. The reasoning these giants of the Austrian school used when they questioned the possibility of efficient allocation of resources without resorting to price signals is quite closely connected to our subject. It was the enormous need for information to solve the problem. In his famous study dealing with the debate on the impossibility of rational calculation in a socialist planned economy Hayek writes: "The distinction of having first formulated the central problem of socialist economics in such a form as to make it impossible that it should again disappear from the discussion belongs to the Austrian economist, Ludwig von Mises. In an article on *Economic Calculation in a Socialist Community*, which appeared in the spring of 1920, he demonstrated that the possibility of rational calculation in our present economic system was based on the fact prices expressed in money provided the essential condition that made such reckoning possible. The essential point on which Professor Mises went far beyond anything done by his predecessors was the detailed demonstration that the economic use of the available resources was only possible if the pricing was applied not only to the final product but also to all the intermediate products and factors of production and that no other process was conceivable which would in the same way take account of all the relevant facts as did the pricing process of the competitive market." (*Hayek* 1980, p. 143)

The role of the market price mechanism in mediating and concentrating information and also its resulting impact on the reduction of transaction costs are issues of common sense in economic analysis. The same is true for the impact that the prices of capital goods—used in the production process—exert on costs and thus also on the prices of products. It seems, however, that agreement on the beneficial role that the market price mechanism plays lasts only as long as we are talking about prices as orienting signals in the flow world of the economy. Market prices, however, do something else as well: they determine the value of asset portfolios—at least as far as that portion of total wealth is concerned which consists of assets having more or less organized markets. Therefore—like it or not—the wealth positions of economic agents depend to a large extent on the current prices of certain assets, or on the future changes in those prices.

[9] If I am not wrong in interpreting the New Economic Mechanism introduced in 1968 in Hungary as a clandestine admittance of that.

If we find the separation of the roles of savers and investors normal in the modern economy, then we have to accept as a natural consequence that savers do not care much about what final economic action or exactly what project is financed through the mediation of markets and financial intermediaries out of their own savings. We hold a significant portion of our accumulated wealth simply for its return. Saving and accumulating for financial return regardless of the use of the funds could be regarded as self-centred and out of touch with the real economy being a quest for value or profit instead of caring for the "really important" value in use. This interpretation would, of course, misunderstand the significance of the division of labour and its role in improving efficiency, as well as the role that the market mechanism plays in coordinating capital movements; in the same way, overemphasizing the "value in use" misunderstands the same role of the market in the world of flow activities. As a result of this division of functions and specialization, the financial system gains a significant degree of independence. We all benefit from these developments due to the fact that new methods used by financial markets for pooling and "repackaging" funds, as well as refined methods developed for handling risks, created a scale and variety of financial opportunities that had never existed before. As a result of this, in the process of a parallel "inflation" of assets and liabilities, beyond their traditional services of mediating between investors and savers, financial intermediaries offer an unprecedented variety of forms for holding wealth. Agents can choose according to their preferences for terms, risks and returns.

If, however, the saver holds his savings for the return he gets, then it would not count for him whether the source of this return is an increase in the flow of production (assisted by real investments made possible by the savings he has accumulated), or simply a change in the prices of assets. Due to the high level of sophistication the system has achieved, the saver (e.g. a deposit-holder at a bank, an owner of an insurance policy or a retirement fund) would not even have a choice about the control of the final source of the return of his investment, even if he wanted to. Expectations towards returns by savers, as well as market competition among financial intermediaries, force market participants to exploit all possible sources of returns. As a result, it is now absolutely impossible to draw a dividing line between those market activities which are aimed at pure speculation and others. Besides, it is worth mentioning that economic theory does not attach that type of highly negative value judgement to speculation as does the current public ethic in Hungary.[10] There has, of course, always been speculation and even derivative instruments, which make so much noise in the money markets now, were invented hundreds of years ago.[11] Nor should we assume that people's desire for gaining

[10]For an argument on how speculation can play a stabilizing role on the foreign exchange markets see, for example, *Friedman* (1953).

[11]"... options, forward contracts and futures have been around since the 17th and 18th Centuries in Europe, the United States and Japan." (Merton 1995, p. 5, footnote)

wealth has increased dramatically in the past twenty years and thus this explains the boom in stock exchange transactions. It is true, however, that asset transactions had much higher costs in earlier times. The degree to which transaction costs could restrict trade in assets is easy to assess, even by people who have no training in economics at all: for instance, by anybody who has tried to sell their home or similar high value wealth items. If transaction costs are high then quite significant changes in prices (or an expectation of such changes) have to precede any sale or purchase of even those assets that are held exclusively for their returns. This precondition seriously restricts the number of those asset transactions. From the point of view of the final user of the capital resources—and the ones who have the vision of an overpowered financial sector might consider this the "correct" point of view—the low level of liquidity, due to high transaction costs, ensures the stability necessary for conducting production activities. For example, it would be quite difficult to produce ships if those owners of capital sensitive to changes in returns wanted to withdraw the capital they had invested in shipyards as a result of some tenth of a percent change in the returns and wanted to reinvest those in some far away sectors. One should recognize, of course, that the value of this kind of stability is quite dubious if we look at the picture from the investors' point of view, given that they are interested in the returns only. From the investor's side the story is that, due to the low level of liquidity of this investment, he has to absorb a significant loss in the form of a decreasing value of his investment, owing to the fact that his opportunities to withdraw his funds are quite limited. Knowing that, one would think twice before investing in shipbuilding.

The modern system of finances carries out the difficult task of matching the needs of those who create the sources (savers) with the final users (investors) of those funds by making the length of the intermediation chains and financial channels longer. The long chains of finance, often crossing each other, undoubtedly distance the financing decisions from the real economic activities for which they eventually provide a source. This makes many financial transactions relatively independent of the real sector. In this sense one can talk about the financial sector "breaking loose" from the real economy. Before jumping to conclusions too early, however, one should keep in mind that, without this relative independence, much of the resources for financing would not be created at all, as most of the savers do not have the intention of investing directly into real production activities.

The development of information technology, the reduction in transaction costs, the fast growth of financial markets and the development of new theoretical results (as well as practical methods) have gone hand in hand in recent decades, helping and challenging, strengthening and accelerating each other. New results, methods and types of transactions have, partly, exploited opportunities provided by the earlier ones, and they have also tried to solve or at least handle problems created by the development itself. Now, huge funds can move from one form into another, from one denomination to the other, in the globally organized markets.

This takes place through exchanges of fully homogenous financial products at very low costs, compared to the value of funds exchanged. This high level of liquidity, and the plentitude of very similar and easily accessible investment opportunities, gives a much larger room to manoeuvre and safety for the investor. However, by its very existence it increases the probability of price changes and consequently the risk of changes in returns. In such an environment, even the anticipation of relatively small changes in prices would induce large offers to buy or sell, and therefore sudden increases in the demand and supply of financial products would result in further changes in prices. Increased volatility in financial markets called for development of market-conforming insurance methods: first the theory of identifying and handling risk was worked out; then—relying on theoretical results—special types of transactions capable of handling different cases of risk, among other things the often cited derivative products and transactions, became popular.

Economic literature warned very early, that the low level of transaction costs in some markets would result in growing volatility and price instability or, more concretely, it could result in self-fulfilling speculative attacks. Assessment of these new phenomena was first carried out with respect to markets of foreign exchange. A potential remedy against speculation waves, the famous Tobin-tax (*Tobin* 1978), also attributes the problem to low transaction costs and suggests that a small levy on foreign exchange transactions should be charged "to throw some sand into the wheels of our excessively efficient international money market" (p. 154.). Considering this on a rational basis, suggestions for regulation of the financial sector only make sense if they try to solve or handle real, existing problems—like too much risk-taking or instability. The mere fact that this sector grows faster than others, or that one can earn more here than the average, are not enough to justify strict regulation.[12] Given all this, growing volatility in financial markets is a fact; therefore suggestions for those regulatory measures which can increase market stability without reducing efficiency and increasing transaction costs are truly welcome.

Parasitic behaviour and growth at the expense of other sectors

Besides accusing the financial sector of having broken loose from the economy, critics often claim that it is parasitic, exploits the other sectors, or at least it draws the investment funds from other sectors—i.e. from the "really important" real activities of the economy. It is quite interesting though, that claims like these are never ever supported by any economic analysis of exactly how or through what channels this redistribution of income and wealth would take place. Questions asking for the mechanisms of these processes are not even raised, even in the more

[12] For an analysis on the significant difference between wanting to discipline or to regulate financial markets see *Király and László* (1999).

serious (that is, less ideological) papers; the fact that fast development of the financial sector happens at the expense of other sectors of the economy is taken for granted. Casual empirical observations—such as those which note lively activities experienced in the monetary sector while at the same time some (often crisis stricken) branches in the real sectors suffer from a lack of capital, or that returns on certain financial assets are significantly higher than returns on some (accidentally chosen) real assets—serve for many as "proofs" of the alleged exploitation of the real economy by the financial world. Higher returns on financial assets—so the argument goes—make it possible for the financial sector to attract resources from the "real" economy.[13] With these views circulating in the professional media, one should not be surprised if many editorials in daily papers consider higher than average salaries earned by bank staff and the representative buildings and offices banks and insurance companies regularly have, also as signs which prove they are parasites. A hostile media keeps implying that a crackdown on the monetary sector and on its representatives would result in a more just distribution of income as well as wealth.

It is quite clear, of course, that this accusation about parasitic behaviour is also heavily packed with the type of value judgment which sees hierarchies among human economic activities on the ground of value judgments; such views discriminate against certain types of activities, regardless of those valuations that are expressed in the form of market demand for them. With certain values set *a priori*—that is, with a given definition of fairness—one can always assert that some incomes should have been realized by others and not the ones who actually earned them. But these *a priori* value judgments cannot be justified by economic theory and that is why this study tries to avoid this side of the issue. Economic analysis of financial markets and the mechanism and economic role of financial intermediation would not only refute the accusation of parasitic behaviour: economic analysis statements of such a nature would not make sense at all.

Let us start again by considering the most important role financial markets and institutions fulfil in the economy. This sector mediates and channels funds saved in various sectors of the economy to investors of other sectors. In this process they offer various services in terms of pooling, mediating and "repackaging" funds, with hedge and insurance facilities against different types of risks and so on. With all this it helps with the specific needs, and the demands of savers and investors—originally quite far from each other—get closer. Income that the sector earns eventually comes as a fee for the mediation itself or for the services rendered. The fact that these fees are literally charged as service charges, or in the form of margins between the deposit and loan rates, or take other forms does not belong to the essence of the problem. Concerning incomes, therefore, if one wants to prove

[13] For allegations such as these in the Hungarian literature, see Sándor *Kopátsy* and György *Matolcsy*'s, especially Matolcsy 1998.

the financial sector's parasitic behaviour, one would have to demonstrate that, in the process of financial actions, it charges unjustifiably high mediation fees and the services it sells to customers are overpriced and/or useless. Therefore those players at the two ends of the financial chain who do not belong to the financial sector would be harmed and exploited.

The financial sector, however, is not an authority—it cannot force its customers into buying its services. The complaints listed above are reasonable only if there are strong monopoly positions in the intermediation sector, which rely on the excessive use of economic power. Of course, we cannot exclude the existence of monopoly positions and even the resulting rent-seeking behaviour, even in the case of the financial sectors in the respective developed market economies. At least, that was the case up until the seventies: before the current, speedy development experienced in the financial sector, monopolistic positions were partly attributable to the specific features of government regulation restricting competition in the field (this was the case in the US); and they were partly caused by the limited sizes of the national financial markets (in the case of Europe). Since then, however, the financial market has become fully globalized and market competition has become fierce. This statement, I suggest, does not need any specific proof.

The situation has been somewhat different with the new market economies of East Central Europe because they started out with virtually no modern financial infrastructure at all. Customers here had (have?) possibly more reason to complain. Lack of experience due to low level of development, initial problems in the field of regulation and control and similar child diseases made intermediation of resources much more expensive than it is in the developed countries.[14]

The rent-seeking of the monopolies can truly be regarded as parasitic behaviour. But even in this case the problem is not the financial superstructure, but the monopoly itself; this has similar and no less harmful consequences than in any other sector and can be criticized the same way. No doubt the central position of the finances and the huge size of the funds mediated give a larger scale opportunity for monopolistic rent-seeking here; this costs more for the society than, say, monopolistic rent-seeking performed by wholesale distributors of groceries. All we can conclude from this, however, is that monopolies can do more harm in some fields than in others. It does not follow that a monopolistic structure would necessarily be a feature of the financial sector as such.

It is even more difficult to find some rational basis for the accusations that the financial sector takes away capital, that is stock, resources from the real sector and in this way harms the development of that sector. Those who want to save the real sector from the competition for funds that allegedly sets investments into financial products against investments into the real sector certainly misunderstand

[14] Specific problems facing financial intermediaries in the transition economies are discussed in *Rostowsky* (1995).

the very nature and essence of financial wealth. They do not seem to notice that investing in a financial asset or investing in a real asset do not constitute the same alternatives as investing in, say, the manufacturing industry or in the agriculture. As the financial sector is a mediator and not a final investment option for real capital, redistributing real capital from the real to the financial sector is simply impossible. Real wealth can be redistributed from one sector of the real economy to another sector of the real economy. Similarly, it is not the real and the financial sector who compete for funds available for investment but the real sectors compete with each other, while the financial sector, financial markets and intermediaries stand in the middle as mediators. As mentioned above, this is the main role of the financial sector in the economy: to mediate and channel funds among different users.

Financial institutions (or rather, their owners), of course, also own real wealth. One can always say that, instead of raising a bank building, one could have used the resources to build homes. It is true but it is not a very deep observation, and does not refer to the real question under discussion here. The value of the real capital used by the financial sector while doing its job is very very small compared to the funds it mediates and to the volume of the assets it trades. Therefore, for the sake of simplicity, in the arguments that follow here, the real assets owned by the financial sector are completely ignored, and the term "financial investments" refers to investments in financial assets proper.

There is a basic difference between real wealth and financial wealth. Financial assets constitute debt. At the level of the individual portfolio holder, pieces of real wealth (a home, a plot of land, or a car) and financial wealth (like bonds or money) can be added up: together they constitute the total wealth of the individual. At the macroeconomic level, however, the two elements, real and financial wealth, cannot be added up because financial wealth is somebody's liability. In the process of aggregation, mutual liabilities cancel out and therefore the total wealth of the whole society is real wealth only.[15] While an individual can restructure his portfolio between real and financial wealth by, say, selling his house and buying government bonds from the proceeds, the whole society cannot exchange real wealth for financial wealth. The house is still there but the owner is different: bonds still constitute government debt by the same value, all that has happened is that the government is now in debt to someone else.

Contemporary money is called money without internal value, but the same feature is shared by all financial assets. They are considered to be valuable because they constitute promises of payments, not for their characteristics with respect to consumption or production. The goods that are valued for those characteristics are

[15]For the sake of simplicity, in this argument it is assumed that the economy is closed. International capital movements complicate the issue beyond what can be dealt with here due to lack of space. Still, the presence of international capital relationships does not change the conclusion.

the real goods. The fact that financial products do not have any intrinsic value explains why—just like money—they can be produced virtually without limits and without costs; furthermore, the financial sector is able to inflate the levels of assets parallel to liabilities with no limits and this does not require any significant use of the real resources of the society. At the level of the macroeconomy financial assets are not tools for accumulating wealth—rather, they are tools for efficient trading in assets and for the efficient redistribution of resources.

Real wealth cannot be produced simply by using ink and paper, or computer entries. Financial wealth can. The real wealth of society increases only if the society produces more than it absorbs (consumes). The financial sector cannot create and cannot eliminate real wealth, and it also cannot make financial wealth out of real wealth. If society saves something in real terms, it has to show up somewhere as an increment of real wealth. Therefore, if someone buys a financial asset (say a bond) it does not mean that he has favoured investment into the financial sector instead of the real sector—rather, it is the case that he has let some users in the real sector borrow his resources through the mediation of the financial sector instead of lending it directly to real sector users.

Given this, what explains that apparent and often criticized observation that the returns offered by financial assets are often significantly higher then the returns from direct investments in the real sector? In fact, in most cases this is only apparent, not real. Financial assets are measured in nominal terms; during inflationary periods a large part of the returns resulting from them is compensation for the loss of the principal due to inflation. In the case of real assets their value follows inflation—compensation is not needed. The remaining (inflation adjusted) differences in returns can be explained by the fact that not all users who compete for funds accumulated by savers intend to use those funds for real capital accumulation, let alone for productive investment. If someone saves and lends his savings to someone else who uses them for consumption purposes, then this action does not increase the total savings of the society and total wealth would not change. In this case the individual saver has invested his real savings into a financial asset (i.e. into a loan); but, yet again, the financial sector has played the role of mediator only. The loan that has been mediated enables another participant of the real sector (a consumer) to consume more than his earned income. It is true that in the process the real savings disappear and a new financial asset is created, but the party taking real resources away from real investments is not the financial sector—rather, it is the consumer.

On the demand side of the market for capital resources, beside those who intend to invest funds in real productive capital, there are also those who intend to use those funds for consumption purposes, probably at the expense of their later incomes. The competition of these participants may result in their driving funds away from real investments. As the intermediation of funds goes through the long and complicated chains and channels of the financial markets, all that one can sense on the surface is that the strong demand for funds pushes up the interest rates. Potential investors into real projects are often crowded out as they cannot offer returns as high as the ones borrowers for consumption are willing to pay.

Household consumption loans can reach quite high levels inside the private sector and thus there is some competition between consumption and investment. However, consumer loans in general are limited by the market process itself. Borrowers' ability to earn income in the future and so repay the loans is considered a risk by lenders—moreover, the resulting increase in the interest rates can also rebuff the surge of consumer loans. Households in general are net savers in a market economy—namely, they are net suppliers rather than demanders of funds. Government borrowing has a much more significant impact on the level of rates than private consumption. What is more, the government is much less sensitive to costs than the private sector, and therefore the higher rates do not drive the government away from borrowing private sector funds. The way government borrowing crowds out private investment is well known and amply discussed in economic literature. When buying a government bond the citizen does not express a preference towards the financial sector as opposed to the real sector—rather, he prefers his own government (that is, the high returns paid out of taxpayers' money) to the economy as such.

As the analysis above indicates, there is not a grain of truth in the allegations that the financial sector drags away resources from the real sector by offering higher returns on financial assets. While those differences in returns can easily happen, it cannot be caused by the system of financial institutions given that these only mediate in this process. It is not the financial system but rather some other users all belonging to the real sectors—to a smaller extent consumer borrowing and to a much larger extent the financing needs of a government running large budget deficits—who compete for those resources.

Liberalization of the international capital markets and large scale globalization of trade in capital assets have made financing what it is today and therefore all the related issues discussed above are much more complicated and less easy to see through than they used to be. Now local investment projects have to compete with projects literally all over the world for financial resources, while at the same time they have the chance of being able to draw funds saved somewhere far away in the world. The problems raised by globalization constitute another important aspect of the questions which have been discussed in this article. Analysis of those issues, however, would require a completely separate study.

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A DECADE OF TRANSFORMATION: RUSSIA AND HUNGARY COMPARED

L. CSABA

The study attempts to resolve why Russian and Hungarian transformations have taken different routes and different dynamics. The author offers eight stylised facts describing the most important components of divergence. In the interpretative part he argues against using path dependency as a cheap excuse for mistaken policies, highlights the role of social learning and the need to put proper institutions in place of fostering savings and investments. This helps endogenising capital formation and thereby making realistic forecasts of future growth potentials of the two countries that are likely to remain different for the long run.

Introduction

It would be difficult to find two countries that are more unlike than Russia and Hungary. Size, history, factor endowments, the role of ideology and ethnic and regional strains are all different. Still, at a certain level of abstraction, it is worth comparing the endeavours and accomplishments of these countries' respective policies and the related spontaneous developments. All the more so, as their respective starting points were actually the same. As I tried to argue earlier (*Csaba* 1995, Chapter 2) both of them were *integral parts of the same system*: the Soviet empire. Systemic change in Hungary and also in Russia cannot be meaningfully interpreted without mentioning the historical changes that have taken place in the second half of the 80s, culminating in the eclipse of the empire. Likewise the professed *priorities of policymakers* in both Russia and Hungary *have been the same*: "The return to normalcy", or in other words, "becoming a normal European country". Also the roads adopted contain a series of similarities: with varying degrees of success the standard panacea of stabilisation, liberalisation and privatisation followed by institution-building have constituted the backbone of overall transformation policies.

In this study I want to take a bird's eye view of the truly historical rearrangements in both countries. In recent years serious and reliable economic reporting on the twists and turns of current economic life has emerged, not least owing to the massive involvement of such organisations as the IMF, the World Bank, the OECD and the EU. Each has been running its technical assistance programmes and these have involved a large number of officials and professional journalists as well as statisticians. While one can always debate about details, there are always alternative interpretations, and we do possess some cornerstones for making overall evaluations.

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According to comparable data (*ECE* 1999, Appendix, adjusted for preliminary 1999 data) GDP in Russia stands at 54 percent of the pretransition level, while in Hungary it has recovered. In terms of consumer expenditure, Russian data stood at 84 percent in 1998, while Hungarian data stood at 90 percent. In terms of investment, real gross capital formation in Hungary was 115.4 percent of the 1989 level in 1998, while in Russia it was only 18.5 percent. Inflation in Hungary in 1999 was single digit, while in Russia it is about 80 percent on a year-to-year base. Unemployment in Russia was 13.3 percent in 1998, in Hungary 9.1 percent, with the Russian figure growing to over 14 percent and the Hungarian one diminishing to 7.1 percent in 1999. In terms of FDI Russia has attracted USD 10 bn and Hungary USD 20.5 bn, of which in 1997 Russia attracted 6.2 and in 1998 2.1; in Hungary both years saw approximately USD 2 bn of FDI. Russia's total exports—registered from 1991—grew from USD 47 to 58 bn in the period of transition, fluctuating widely year by year, while Hungarian sales abroad grew from USD 9.6 to 23 bn between 1989 and 1998. The share of SITC (machinery and equipment) was below 5 percent in Russian and over 53 percent in Hungarian exports for 1999. These are signs of structural rigidity in one case and structural improvement in the other.

Whatever we think of the meaning of individual indicators—i.e. recovering pretransition level in an entirely different structure, or the way one could possibly convert inconvertible currency trade into dollar values—the *divergence of development paths* seems to be beyond doubt. One wonders how to explain this in *economic* terms. This is an important issue if we want to eschew the widespread flight to anthropological, culturalist or historical philosophical grand explanations where economics is just one of the side conditions.

This study tries to offer an explanation in terms of *transformation strategies*. The underlying assumption is that the related set of policies and institutions—jointly and aptly called in German *Ordnungspolitik*—does matter. While obviously not being the sole explanatory variable, this set of factors is able to interpret *both cases* in standard economic terms, without having to resort to exogenous variables, historically predetermined schemes or world conspiracy theories—all falling outside the scope of standard scientific reasoning.

Our adherence to comparative economics does not make other approaches superfluous. On the contrary: historiography will have a lot to explain why and how individual decisions have come about. Sociologists are likely to theorise further on the group-formations and interest representation that have formed the outcomes. Many other approaches seem equally appropriate. The starting premise is that description of economic trends in both countries is widely available to all those interested in the details. From the IMF to the OECD, several research institutions and rating agencies as well as banks produce regular overviews.

The comparative systems approach operates with *stylised facts*. Here an attempt will be made to present those which may sufficiently describe the salient features of transformation strategy. This approach is strictly *descriptive*, i.e. it does not attribute normative value to the features, nor does it approve them in a *post hoc, ergo propter hoc* fashion. The model is a verbal one, and it is neither all-embracing nor exhaustive. It aims to highlight those features which form the backbone of the actually emerging order, reflecting *Ordnungspolitik*—i.e. the *outcome* of actual *measures* aimed at shaping policies and institutions, and *channelling* the predominantly spontaneous processes of systemic transformation.

It is important to emphasise the *overwhelming spontaneity of the overall process*, insofar as a large and growing part of the literature tends to attribute all or most outcomes to (mistaken) conscious policymaking. This explains the fashion of trying to devise new and alternative philosophical and policy-frameworks, even new paradigms for interpretation—primarily in the case of the Russian failure.

This is obviously wrong, at least for two reasons. *First*, in terms of epistemology, theory-building deserves its name only if it is able to offer an interpretation for successes and failures alike within the same theoretical frame. *Second*, as has been documented several times, the eclipse of the Soviet empire was a historic cataclysm. In a way, nobody could predict it, as far as timing and scope as well as its trajectories were concerned. Therefore policymakers and also households and companies had to *adjust to conditions of extreme uncertainty*. Governments often receive reliable—i.e. final—statistics only 9–18 months after they have instituted the related measures. Likewise, households and companies had to adjust to rapidly changing signals such as positive and negative rates of interest, the widely divergent profitability of various activities and the like. Therefore—reflecting the crisis-born and thus inevitably chaotic nature of changes—*conscious policies have had very limited influence* on the outcomes. Of course, policies matter, but certainly they do not matter as much as they do in a standard model. Calibrating macro-variables was a hopeless task for most of the period under scrutiny.

It is important to stress that this is not an *ex post* rationalisation of the chaotic outcomes of allegedly mistaken public policies of the transition period. Highlighting the inevitably growing spontaneity as a sign of erosion in the coordinating mechanism of the respective countries has been a well documented topic in the periods preceding transition, both in Hungary (*Antal* 1985) and in Russia (*Naishul* 1991). Thus it was too naïve or ignorant to believe that just by putting "the right men in the right places" everything could or should have been changed for the better. The fact that such beliefs and expectations have been widespread, qualifies only those who have ever cultivated—or sometimes politically instrumentalised—them.

Thus the comparative systems approach adopts a *narrow but coherent angle* of looking at things from a given perspective, measured against the underlying logic of systemic change. It takes the *conventional wisdom*, as reflected in the *World Bank* (1996) and OECD volumes (*Zecchini* 1997), *as given*. Putting it briefly there is a certain substance and sequence of transformational measures which have, both in theory and empirically, been conductive to overcoming chaos and hyperinflation, meanwhile putting those who have succeeded on the path of sustainable growth. The latter is not automatic but it is, however, not constrained any longer by transition-specific obstacles. In this latter phase issues of capital formation (*Kolodko* 1999) come to the fore. This implies a regulatory environment supportive of domestic savings, lowering corporate taxation, shifting to indirect taxation applying a small number of rates and widening the tax base.

In this framework transition is *not a journey from the unknown to nowhere*. While history matters, and the type of capitalism emerging in the long run is likely to differ country by country, there is a discernible way, a *minimum of necessary measures and means*—the stabilisation, liberalisation, privatisation or SLIP strategy—*that cannot be saved* by any successful candidate.

It remains, of course contestable, whether it is historic-institutional legacies which allow or do not allow for the "right" policy mix, or conversely, policies are dominant in shaping institutions. However, this is another level of abstraction where issues of philosophy rather than policies aimed at institution-building can be discussed. For the present study we remain at the level of more applied economics in comparing and contrasting Russian and Hungarian experiences in the same period.

As a counterfactual but plausible theoretical assumption we may advance the following. According to all standard economic theories, *Russia has had more favourable conditions for success*. Its resource endowments have been richer. Its power structure was more intact at the outset. International attention and assistance were more forthcoming to a superpower, than to a country of 10 million, if for no other reasons than its weapons, environmental decay and the threat of migration. In early transition theory, the long reform experience of Hungary also tended to be portrayed as a disadvantage, since it had created in-between forms of ownership and rendered the dividing line between pre- and post-transition conditions unclear.

As trivial, textbook-like *assumptions* and observable *outcomes*—as reflected in the statistical bottom line presented above—*are conspicuously incongruous*, it is worth making an effort to interpret the two country cases as two models. These exhibit *opposite dynamics on the transition path* circumscribed above. The common starting point and the obviously discernible commonalities in all transitions from plan to market make it possible to find a *common dimension* for comparison.

The Russian case thus seems as an earnestly intended, but not fully implemented, attempt to remodel the Soviet legacy. The basic problem here is not so much the cost in terms of lost output or lost opportunities, but the steadily declining support for reforms, the erosion of the 1992 and 1996 reform coalitions. There is also the close-to-consensus professional view, recently summarised in English by *Sapir* (1999), that reform have been fundamentally misconceived and poorly implemented. In this view the Russian failure is a call to rethink economics and the "conventional wisdom" on transition theory.

One of the several problems with this generalisation is that Hungary does not in any way fit into such a case. The *"same" policies have delivered fully different results*, with the "conventional wisdom" making increasing sense to a growing number of analysts inside and outside the country. In a way it has been a case of ever more radical reforms gaining increasing support from the public and the profession alike. Despite obvious discontinuities in terms of social support, ideologies and aspirations, the Németh, the Antall, the Boross, the Horn and the Orbán governments have all adhered to the fundamentals of a reform policy, adding up to what is called a sustainable policy line in the longer run (for empirical evidence see Csaba 1998a). If Russia is a case of *self-destruction*, Hungary is one of *self-fulfilling* reform policies, along the lines of the "conventional wisdom" on transition.

The stylised facts

1. Probably the most conspicuous difference between Russia and Hungary originates from the different *role of the state.* In the case of Russia the ongoing erosion of the state that has been discernible from the second half of the 1980s and this fundamental factor has shaped everything else. In what had been called by contemporary analysts a confrontation between branches and layers of power, a dangerous game emerged. This has involved a series of fights—Presidency versus Party under Gorbachev, Russia versus Soviet Union until 1991, Presidency versus Supreme Soviet until October 1993, centre versus regional power (exemplified by the Chechen War in 1994–96), and the ongoing fight among the various interest groups, the "oligarchs" in 1997–99. These have all left lasting wounds. In a nutshell neither a democratic nor an authoritarian régime has emerged, but each fighting party has left its adversary weakened. *In other words, winners have also been enfeebled in a lasting way.*

This explains to a large extent the recurring problems with the economy as well. The failure of stabilisation efforts in 1995–98 was basically due to the unsustainability of fiscal policies which were incongrous with exchange-rate stabilisation policies. These could not be saved by the belated and, in its own terms, insufficient international assistance (for the narrative cf. *Malleret, Orlova and Romanov* 1999). Nobody ever believed that a general government deficit in the range of 6–8 percent of GDP was sustainable with the central government collecting only 10–11 percent of GDP in revenues. However, it is equally true that nobody faced the fact that it is *no longer up to the will of fiscal planners in Moscow* to change the established distribution of tax revenues, with two-thirds going to local powers and the rest to the centre. This is not a matter of insight, it is a matter of power relations.

Since Yeltsin conducted a traditionalist policy of buying-out opponents, combined with the maintenance of an atmosphere of crisis which only he was able to manage, the *continued weakening of formal structures* has been an inevitable by-product. As a consequence, a wide variety of mostly autocratic régimes have co-existed within the federal state, and the central power has had little leverage over these (*Gelman* 1999). By the same token, the rule of law could not be established on the ruins of communist lawlessness. Quite in line with what happened in Italy, China and in the US in the last century, violent entrepreneurship based on private enforcement techniques (*Volkov* 1999) has gained the upper hand. This is neither a surprise nor a perverted form of market economy, but it is the way it functions in the absence of some side-conditions normally postulated in economic theory.

The collapse of the totalitarian state has not given way to the free market, as some naive reformers postulated but, quite in line with neoinstitutionalist theories, informal institutions have become dominant. In other words, strange but *per se* rational, in-between forms of coordination have emerged, where *neither bureaucratic nor market coordination has prevailed*.

It is worth noting some of the basic features of this arrangement. It has allowed for unprecedented degrees of rent-seeking (*Aslund and Dmitriev* 1999) and this has had two faces. *On the one hand*, it has created the famous first dollar millionaires, and a capitalist class that many sociologists considered impossible, given the long decades of Soviet rule and indoctrination. *On the other hand*, it has robbed the market order of any kind of legitimacy. Non-market parties are likely to continue to dominate Russian legislation for a long time, and major social powers all legitimise themselves with market-restraining ideologies.

Meanwhile, the state could not be instrumentalised by the new business groups as is often asserted in Russia proper. As *Schröder* (1999, pp. 980–981) convincingly demonstrated, the financial oligarchs care basically about their own business. Their involvement has remained *restricted to their areas of primary concern*, like limiting foreign penetration, and securing rents of various sorts. However, they have fallen conspicuously short when it comes to producing an ideology, or being involved in shaping foreign policy or defence priorities, or shaping state affairs outside their own narrow economic interests.

Pursuing these interests was hardly possible without resorting to state power, since devolution of authority and the rule of law have not emerged. The Russian market economy is a state capitalist model, where *neither the free market nor a state-run economy is feasible* any longer; yet, without the continuous penetration of state power no strategic economic interest can be asserted (Csaba 1998b). This has two implications, retroactively supported by the Kirienko-Primakov-Stepashin-Putin episodes. First, there is no way back to fully-fledged authoritarian rule but reformist breakthroughs are equally blocked. Second, an acceptable level of moderate inflation is a common and joint interest of all players, whereas *economic growth is neither necessary nor possible* under these conditions. Where less than 1 percent of savings is going through the formal capital market, where the overall environment is investment-deterring, *capital flight* rather than accumulating fixed assets is the economically *rational* strategy.

In the case of *Hungary* the role of the state has been slowly but steadily growing. With the steady decline of the share of public property from 75 to 15 percent of GDP in 1989–99 traditional vested interests and ambitions of production and distribution have withered away in all areas except for the still overregulated—and contracting—farming sector. Thus the real power role for the administration is *regulation, not ownership*. Those who could have a say in the ways and procedures of privatisation deals could influence the outcomes in a much more lasting fashion than those deciding over market protection or public investments.

Arrangements for the contemporary Hungarian state have emerged in the process of a negotiated revolution (*Tőkés* 1997), i.e. there were no dramatic disturbances. All participants around the national roundtable were frightened of disintegrative processes. Thus the handover of power secured the position of most of the civil service, but the successor party of the communists was unable to play a dominant role. Following the deal of the two major non-communist parties in 1990 the *constructive vote of non-confidence* was introduced. This arrangement, borrowed from Germany, implies that the Premier alone is responsible for governance. He can be removed only if those voting him down can immediately agree about setting up a new government. This is highly unlikely, partly due to the strong majoritarian element in the election system. Thus the full four years parliamentary cycle of any elected government has been secured.

In contrast to Russia, it is legal arrangements rather than factions or components of the power structure which *ensure the smooth functioning of the state*. One of the important innovations of the negotiated revolution was the setting up of the Constitutional Court with basically unlimited jurisdiction. The Court can overrule any law passed by the parliamentary majority, if it is not in line with the fundamentals of the constitution as interpreted by the court. In this way a *de facto* second chamber exists which lacks elements of interest-representation. Its only interest is to serve the rule of law. Judges serve 9 years and they cannot have another term. Thus a very large degree of depoliticisation and judicial independence is given.

This complex arrangement allows for the separation of a *short-term contest from longer-term reform projects*. The latter require, as a rule, two-thirds of the votes of MPs, and this necessitates cross-party agreement on the fundamentals. These features do not allow party politics and short-term voter-moods to predominate. It turn, governments are *in a position to take unpopular decisions* that serve the longer-term interest of the community as a whole. Large-scale privatisation deals, social security reforms and adjustment packages may serve as examples.

This stable arrangement has allowed the *National Bank of Hungary* to emerge as a truly *independent institution*. The Bank is not the only institution constraining the freedom of the government—it is one of the checks. It has earned a very high reputation as a non-partisan institution preoccupied with money stability alone.

The major accomplishments of the Bank are the following. First, Hungary was not forced to resort to hyperinflation to eliminate the postcommunist monetary overhang. Inflation in Hungary peaked in 1991 at 32 percent on an annual base. Following the surprise inflation of 1995—28.2 percent—(which was needed as part of an adjustment package) inflation has been steadily decelerating from 18 percent in 1997 to 14.3 percent in 1998 and around 9.5 percent in 1999 (preliminary). Disinflation seems to be sustainable, and the crawling peg of devaluation of the forint, introduced in 1995, has been steadily diminishing each quarter. Elimination of the crawling peg is likely by the end of 2000, and Hungary has got the potential of lower single digit inflation rates to emerge by 2002, when the country plans to join EU.

Under these circumstances the *rolling back of the state did not mean a disproportionate loss of revenue*. Owing to the reforms of 1987 as well as the avoidance of hyperinflation and the retained strength of the administration, public dues could be collected. Of course, collection can be severed, but the meltdown of state revenues has not been a major problem for Hungary. Whenever overspending has occurred, *corrective measures* on both the revenue and expenditure side *became feasible*, though not always popular. Hungary's public debt peaked at 84 percent in 1995 but came down to below 60 percent of GDP in 1999. Debt repayment policy has constantly been attacked by some political forces which have called for more spending, but the prudent policy could be sustained, owing to the institutional anchors and the retained power of the central state. Certainly, Hungary is ethnically nearly homogenous and its territory is small. But the fact that business groups did not need the state for their purposes, and the presence of a strong foreign ownership (currently owning over 35 percent of national assets) made *bargaining* with the state *economically decreasingly relevant*.

2. A major difference between Russia and Hungary is the *role of special interest politics*. Pluralism obviously does require the formation and representation of special interests in an organised fashion. However, it is a world of difference whether these *constitute* or merely *influence* the workings of the polity.

If we include both regional and sectoral interest groups, the predominance of these is trivial in the Russian case. In Russia local power in terms of regulatory peculiarities and relevant legislation, even in terms of tax rates or the freedom to trade in foreign currencies, became dominant all during the 1990s. Within the centre, at the level of "high politics" the presence of interest representation is palpable, whilst the formation of more established political parties, typical of mature democraties, that reflect ideologies, lifestyles and values rather than sheer interest, is still in its infancy, after an entire decade of democratisation. Power groupings, like that of Luzhkov or of the pro-Kremlin governors clearly dominate over ideologically posturing parties (the most prominent of the latter being Yabloko). The Communist Party, itself a conglomerate of fractions, is a lasting formation primarily by virtue of representing important segments of *losers in transition*, like the traditional agrarians, the army and the pensioners.

Under these circumstances it is probably not very realistic to expect rules to emerge that are in reality neutral and meant for "eternity and for all". They should be stable, rather than adjustable to each and every case. It is not just a legacy of traditional Russian situative legislation, but it is a reflection of the predominantly special interest politics in Russian democracy, which is reflected in this much criticised feature.

Certainly one may look at things from various angles. L. *Shevtsova* (1999) has recently argued, with some justification, that it is precisely the strong presence of interest groups in policymaking which excludes any return to the previous totalitarian practices in the post-Yeltsin period, even under a worst case scenario. However, she equally strongly emphasises how exactly the same circumstance excludes the emergence of a truly western-type democracy and market economy in Russia. The trend towards an authoritarian solution seems to be a strong likelihood.

In the case of Hungary special interest politics used to be a dominant feature of "goulash communism". One of the reasons why the Kádár régime could survive decades without resorting to massive violence, and actually, why it let changes to happen in a negotiated way, was the strong presence of quasi-formal interest representation. In the case of systemic change the presence of an entrepreneurial stratum with managerial skills and aspirations to become owners met with the priorities of westward-looking intellectuals who led the opposition movements.

Interestingly, the governmental fortress described above implied the decline of special interest policies. The blossoming of small business and the emergence of mass unemployment eroded the position of the unions. This was strengthened by the latter's using social security directorates as a self-service shop. With big business gradually being handed over to foreigners, medium-sized and other local entrepreneurial interest lobbies found themselves fighting each other for the ever smaller portions. With the state continuously selling the best parts of its assets, intra-public sector bargains were by definition constrained to clashes over the remnants.

This state of affairs made it increasingly *unattractive* to be involved in *bargaining with the state as a general survival strategy*. Beyond doubt the conditions of privatisation did matter a lot. Likewise, regulatory terms were also quite important. For instance, with very tough banking and capital market rules from 1992, the business failures of banks and broker firms were dominant, while government-induced crises, such as that of 17 August 1998 in Russia, have been non-existent in Hungary. With the privatisation of big banks there remained *no implicit bailout clause for the public sector*. When one large bank—the politically overloaded Hungarian edition of Credit Lyonnais: namely, the Postbank—was renationalised and saved in late 1998, the reason behind that was not cronyism but care about the bank possessing the second largest retail banking network in the country. It would be hard to establish which group was directly favoured by the act, as the bailout operation actually started in February 1997, under the centre-left government, and was concluded by its successors 19 months later.

Operating an open trade régime from 1989 and with a gradual liberalisation of the financial sector, culminating in Hungary's membership of the OECD in 1996, very tough competitive conditions were created across the board. What could probably not have been attained by any antitrust agency has been secured by foreign competition. Since *no major defences against foreign competition* could be sustained, this took care of shortcomings in Hungarian regulations left open.

The above-described *modus operandi* implies that there is less and less that special interest groups can extract directly from public authorities. The transparent regulatory framework, emerging in the context of OECD membership and EU-accession, leaves very little room for these deliberations to get through. One can document periods during which special interest groups have tried to secure market protection, and tried to slow down privatisation, especially in the energy sector. They attempted to reverse financial liberalisation and advocated spending sprees that would run counter to stabilisation. Reforming the pension schemes to a partially funded system has also triggered serious conflicts of interest. The bottom line, however, is that these could never reverse the process *in toto*. The more often this has been the case, the less lucrative it has been for lobbyists to engage themselves in direct involvement in "high politics" as against trivial and typical activities inside a democratic society. In other words, they do not constitute the fundamentals of the system, but willy-nilly adjust to the overall rules of the game that are not set directly by them.

This also implies a strong party system, where political parties, rather than chambers or unions or informal groups, are the major channels of efficient interest representation. Unlike in Russia, the Hungarian party landscape seems to have been settled. No new parties have managed to establish themselves since 1989. Six major parties—currently converging to four—have stood the twists and turns of parliamentary election. Thus interest groups have to take them as given, to "win" them to their cause, rather than simply delegating them.

3. A third factor shaping transformation in the longer run is its genre. Whereas in Russia capitalism was to be imposed *by design*, the negotiated revolution in Hungary implied the emergence of capitalist institutions through an *evolutionary manner*.

Recalling the highlights of change may easily substantiate this point, which remains valid even though spontaneity has played a major role in both cases. Still, in Russia, not until the adoption of the December 1993 constitution could it be explicitly stated that the target model for the reforms was a market economy. Symptomatically, even at the point of finalising the present text, the basic law of the Russian Federation does not entail guarantees for private property for land, freedom of contract enforcable via courts, and the freedom to start any economic activity without licensing by the authorities (as opposed to registration, where officials do not have the right to pass judgement over the "social necessity and desirability" of the given activity).

This development has a long history, and can be explained by the series of compromises President Yeltsin was forced to resort to, throughout his tenure of office. This fact of life, however, was not exempt from repercussions. Without firmly defined basic principles, like private property, the rule of law, freedom of the individual and the sanctity of contract, regulators confronted with a series of various situations and caught in the middle of conflicting interests possess no firm point of orientation about what to do. This applies quite independent of the alleged or real penetration of the judiciary and the state administration by the mafia, corruption and criminality.

As an important side effect, several items of the Soviet penal code are still on the lawbooks. The former prosecutor general, Skuratov, could hardly have collected over 800 cases of severe economic crime "in the environment of the President" and at the central bank of Dubinin, had he not had recourse to such clauses as the ones prosecuting arbitrage, speculation, and many other operations quite normal in a market economy. This includes switches among currencies, portfolio-investments and their management.

While the constitutional anchor was missing, each reformist Russian government had an *ex post* documentable vision of precisely what kind of market order was to be introduced and how it intended to do so. This was most extensively debated in the Gaider case (*Dabrowski* 1993), and it was equally easy to reconstruct from the more recent policy measures and declarations of Primakov (Csaba 1999). While these projects all had to be subject to amendments and compromises with various special interest groups, the constructivist approach has been just as predominant as the decisive role played by the *nomenklatura capitalists*. The latter situation does not necessarily imply an embeddedness in the communist party: for one, Berezovskii is well-known to have been a lecturer in mathematics, and Chubais a research fellow in economics. Still, what is truly decisive is that the great leap forward was made feasible by instrumentalising the state apparatus, an by converting political positions into economic advantage, rather than producing a series of Russian Bill Gates' and George Soros'.

In Hungary, by contrast, to a great extent because of the absence of grand designs, *closeness to the heights of power have not proved to be a major factor in recruiting the new economic élite*. As recent long-duration sociological surveys (*Róbert* 1999) have demonstrated empirically, cultural capital and/or "ancestors" from the entrepreneurial class of the pre-war period have proved to be more dominant than political capital. The latter has played a diminishing role ever since the late 70s. Interestingly, following the systemic change the political factor has not played a more important role either (this is what some on the extreme right characterise as the "theft of the revolution"). Business experience in running companies, rather than the party card, and even less closeness to the highest decision-making centres have formed the careers of those who have enjoyed longer term successes as entrepreneurs.

As a further peculiarity a very high mobility among the entrepreneurial top 200 or top 1000 has emerged. Those star entrepreneurs who have dominated the news in the late 80s are nowhere today. Also those who made quick gains on spontaneous privatisation have tended to fall behind others (*Voszka* 1997). The major reason is quite simple: those abilities which are efficient in bargaining with the state or making use of loopholes in the regulations are not truly of great help in overcoming the more standard problems of markets. One of these is, of course, the optimal rate of business growth. Misjudging this—i.e. an "ovedose" of ambition—is one of the most frequent reasons for business failures in Hungary.

This might support the otherwise contested thesis (*Szelényi* 1996) qualifying Russia in terms of *political capitalism*, while Hungary is referred to in terms of postsocialist *managerialism*. While the precise scientific operation of the terms may be subject to debate, the message on the different role of political capital and thus of political orchestration for the overall process is clear.

4. *Poetry and reality*. One of the fundamental differences shaping the outcomes of Russian and Hungarian reform policies is one of design and implementation and the interaction among these. Russia has been characterised by a *series of very radically sounding projects*. Starting up from the 500 days programme of Shatalin and Yavlinskii in 1990 to the Kiriyenko plans of achieving single digit rates of inflation and a stable exchange rate in the economy, no Russian government could complain about a lack of ambition. On the other hand, implementation has been shown to be half-hearted or purely formal. This has been inevitable if points 1 and 2 hold.

In the case of Hungary the language of the governments has usually been softer. The country has a long tradition of cultivating the golden middle in economics and politics alike. Meanwhile (as I have tried to document elsewhere in detail) in 1989, in 1992, in 1995 and most recently in 1998 with the launching of private pension schemes very radical packages have been implemented. The reason for this is twofold. On the one hand, the opportunity was created by the legally cemented position of the government and this prepared the way for radical options. On the other hand, the longstanding Hungarian professional consensus on neoliberal basics has allowed for like-minded projects to stand a chance of implementation under various political settings.

This is not to say that the Hungarian way has been politically more innocent or less controversial. Speaking in a soft voice while acting radically implies *very strong ex post resistance on the side of vested interests*. If this is channelled into the political process it is hardly by chance that *no reformist government could gain reelection* over the past 10 years. And conversely, the presidential régime in Russia allowed a degree of continuity that was useful for keeping Russia together as a federal state. However, it also allowed for political continuity under quite different economic policies, allowing standard improvisation in policymaking; this has led to the predominance of absolute short-term considerations over longer term ones.

Thus the *compromise with the status quo has proved to be stronger*, not only more so than the radical vocabulary would have suggested, but probably also more than technical feasibility would have allowed for. The system of non-systematised and non-consolidated bargains, granting a variety of, economically, hardly justifiable tax concessions to the subjects of the federation, is a prime example of a case in which both horizontal and vertical equity, as well as elementary efficiency and budgetary transparency considerations, have been lastingly sacrificed for political bargains of questionable quality and stability. *Aslund* (1999) is quite right in laying the blame for the failure of Russian reforms on these compromises rather than on the much-repeated, but never proved "overdose" of liberalism. These reforms have not brought about more efficient ways of combining resources and thus more growth and welfare.

5. *The role of money continues to be quite different*. While in Russia a lot of time and intellectual effort has been spent on explaining, or conversely uncovering, the vices and virtues of monetarism, reality has been shaped by the ever growing significance of barter trade, state interventionism in production and payments, and the universal spread of payment in convertible currencies. The latter applies to private households, to enterprises and government agencies alike.

When the conventional wisdom talks about the need to enhance the role of money, more often than not the local currency unit is meant. Barter, interventionism and a parallel currency all mean *just the opposite*. The more these are widespread, the lower is the efficiency of monetary policy for managing actual flows in the real economy. If these features persist, the fundamental SLIP tasks are not given the necessary attention, no matter what amount of goodwill and effort is directed towards solving them. *Monetisation* of the Russian economy has been going *hand in hand with demonetisation*, ending up in a quite typical third world *dual economy*. In the latter the modern sector—in this case primarily Moscow—is integrated in the global economy and functions accordingly, whereas the traditional sector continues to function in an archaic—in our case Soviet—fashion.

The capital market crisis of August 1998 therefore had much *less of a devastating impact on the Russian economy* than most external observers have suggested. First, large sections of Russian society have benefited from the backwardness, i.e. from not having been integrated in the modern global economic intercourse. Whatever the fiscal and monetary authorities in Moscow have done or omitted, it has had little, if any, influence on those who run survival ventures, which means most of the Russian farms and the SME sector. It has had next to no impact on the large corporations which barter with one another or conduct their transactions abroad through western banks and in hard currency. The underdeveloped state of financial intermediation, as well as the overall distrust in banks have long established practices of using *cash rather than any intermediation* in Russian business practice. Also, this is the feature which has saved much of Hungary's trade with Russia up until very recently. By the same token, substantial cash holdings of companies, as well as their foreign deposits, have acted as a buffer against the deliberations of the Centrobank in its attempt to subject all of these to the imminent cash needs of the central authorities.

Those who have suffered have primarily been private households who have kept either high yield short-term claims of various sorts (advertised by the banks up until the very last moment), or those having kept their currency holdings with Russian banks. As over two-thirds of private savings are held in hard currency, this is not a negligible stratum of society. By the spring of 1999 complicated swap and guarantee deals between commercial banks and the Centrobank allowed the regaining of about a third of the original value of hard currency deposits. This also means that there is "life after death". Nor did the value of shares, denominated in roubles and held by the Moscow banks, perish in relative terms; thus the *dominant standing of banks* with respect to the owning of industries has also been *maintained*.

The estimated 84 percent inflation in 1999 is also a typical third world economy parameter; the weak government cares about the only leverage it has, thus it has avoided at all costs slipping into hyperinflation. This is exactly what the policies of the Centrobank have aimed at: i.e. supporting the exchange rate at fairly constant levels, rescheduling debt agreements, and searching for continuous pre-election budgetary bargains. The windfall doubling of oil prices in 1999 alone provided the leeway needed for this kind of balancing act.

If Russian developments need explanation, the Hungarian case is more of the traditional textbook example of "how to stabilise". As the monetary overhang inherited from the reform socialist period was insignificant, what needed to be managed were the double shocks of corrective inflation, due to price and wage liberalisation in 1989–92, compounded by the macroeconomic shock resulting from trade reorientation. Managing these did not need inflationary treatment. However, these shocks also precluded smooth stabilisation, lasting only 6–9 months as in developing nations. Also the correction of relative prices in the non-tradable sectors has been a lengthy process, with items such as health care and housing reaching realistic levels of depreciation and profitability only after a decade. The continuous need to manage eternal indebtedness peaked in 1995 and the adjustment package of 1995 also required devaluations which pushed up price levels.

These weaknessess notwithstanding, money has been continuously gaining relevance in Hungary. The abolition of quantitative restrictions in all walks of life, in factor prices, in trade and securing new entries both via trade liberalisation and privatisation to foreign owners, mean that *competition as a system-forming element* has been maintained. With the deceleration of price increases to the single digit level and thanks to the maintenance of high positive real rates of interest, saving in local currency has become a really credible option. Liberalising financial transactions, except for short-term portfolio investment purposes, has created a control mechanism which disciplines governmental policies and business decisions alike. The severing of the law on bankruptcy and liquidation led to dramatic market clearing with tens of thousands of closures in 1992–96. Particular interests—such as the employment of traditional business protection considerations—have been continuously losing out against profitability considerations, and this has speeded up structural change. The mechanism through which it happened was money. Its role has thus become dominant for *households* (giving up the parallel currency), *corporations* (restructing according to profitability and asset value maximising considerations) as well as for *macropolicies* (bringing down public debt from 85 to 59 percent of GDP in 1995–99).

6. As a consequence of the above, the role of the *credibility of policies* has demonstrated *contrasting dynamics* in the two countries. While in the Hungarian case the growth of credibility can be seen through the evolution of expectations of the players on the money markets, regularly buying government papers with revenues nominally below the rate of inflation of the day, in the case of Russia has worked the other way around. The Hungarian system of the crawling peg has proved to be sustainable, with no unplanned or surprise devaluation since its introduction in March 1995. The current account situation of the country has proved to be sustainable and exports even been growing. In contrast, the fixed exchange rate régimes in Russia have been unsustainable and surprise devaluations have periodically occurred.

There is an extensive debate in the international financial literature on the interrelationship between exchange rate régimes and credibility in terms of casual relationships. As a recent cross-country analysis surveying countries with the most diverse forms of exchange rate régimes has convincingly demonstrated (*Szapáry and Darvas* 1999), it is credibility which matters. Wide bands cannot save exchange rates whose credibility is lost, while narrow bands can also be sustainable in the face of a currency crises (e.g. of 1997–99) if the régime as a whole is credible. Szapáry and Darvas proved that in the Hungarian case overall credibility mattered more than the exchange rate arrangements.

Likewise in Russia in 1998 it was not the monetary authority *per se* which lost its credibility, but the overall arrangements. Fiscal mismanagement, originating with the footdragging of opposition-dominated legislative organs, has undermined the credibility and sustainability of Centrobank policies. While it remains an open issue as to the extent of the mismatch, it was foreseeable and inevitable (although, with the benefit of hindsight everybody is wise); nevertheless, the Russian example demonstrates indirectly the need to rely on a broader concept that is not contingent upon a single technical option. If our point 3 holds, the credibility problem is an inevitable consequence. And conversely: empirical evidence of low credibility supports the view recently elaborated by the analysts of the Moscow Business School (*Rossiiskaia* 1999) calling for a renewed emphasis on institution-building and evolutionary dynamics—rather than forcible stabilisation—as the longer term road to a Russian recovery. The problem with this proposition is that it seems unlikely that the higher floors of a building can be built without laying the foundations—and this is what conventional SLIP is all about.

Credibility is not a feature which emerges spontaneously: it must be *earned by conscious policies* at the level of the individual business venture—whether it be a bank governmental agency, or fiscal authority. In the Russian case—where arbitrariness, rent-seeking and the abuse of poor legislation have a long history—this factor seems to have developed into a particularly serious problem which will inhibit progress in the longer run. And conversely: for Hungary the major attraction of joining the EU is in its enchancing the credibility of its regulatory environment (i.e. being broader than just economic institutions). The latter in turn is the externality triggering the snowball of accumulation in accordance with the standard Solow model of catching up.

7. Here we have come to a major component of growth in any economic theory: *capital formation*. In the Hungarian case we see the signs of a self-propelling development or the emergence of a developmentally virtuous circle; the Russian case, however, is the opposite. In the Hungarian case improvement of the regulatory environment and perhaps even more the perception of further improvements, appreciated by hundreds of thousands of economic actors inside and outside the country, is likely to create more investment. This is already happening in the post-1995 period, with not only external but also domestic investments recovering. Favourably inclined expectations translate into bullish business moods which see cheap asset prices, big thinking for the long term, and investment into R+D and fixed assets of various sorts. The relocation of both GE and NOKIA some of their research facilities to Hungary is just as telling as the spread of new hypermarket chains; such moves make sense only if purchasing power is likely to grow consistently in the medium to long run. Investment into big banks, where the first three-four years are likely to be loss-making due to the needs to invest into physical infrastructure, is sensible only if it is anticipated that the demand for financial services will grow exponentially. Likewise, investments in the utility sectors are typically long-run recoupment ventures. Trust and positive expectations are therefore quite important determinants of whether and to what extent physical capital formation is likely to evolve.

In the Russian case the already quoted miserable investment figure is a sign of a *developmentally vicious circle*. The credibility-regulation-expectations chain is at work here too, but it functions in the opposite direction. Due to inflated expectations many disenchanted or deceived investors have been spreading the bad news among newcomers. With the prospect of economic recovery and stabilisation along the international path gone (although it looked immediate in 1997–98) capital flight remains the only realistic wayout. As has been mentioned several times, the central government has very limited leverage over Russian resources of various sorts: financial resources, especially cash—*zhiviie d'engi*—being a very sensitive point; thus the chances for a government-lead recovery are virtually non-existent. This is important to underscore as both in the western and in the Russian literature there is an influential body of opinion advocating the east Asian pattern as a cure for Russian illnesses. In fact, this option, or even a mild Keynesian anti-depression cure, would *presuppose a qualitative jump* in precisely this area. And if severing collection were just a matter of will, it is hard to see why such significant figures as Pochinok or Fyodorov could not carry out the task. Thus, unless we accept obviously untenable basic assumption on the administrative capabilities and the powers of implementation of the Russian state, we cannot really see how this very state could act, and transform itself into a developmental dictatorship of the pre-east-Asian-crisis type. Thus *there is no easy solution involving the inversion of the recipes of reform policies*.

This is not a positive situation at all since the most widespread idea about how to cure Russian decay is through statist schemes of various sorts. These all presuppose that this state is—or should be—able to collect revenues and plan priorities in a way that private markets will never allow. The trouble is that in the Russian case *market failure is a consequence of state failure*. Thus there is no way by which public authorities could form those capital items that are fleeing from its very arbitrariness and expropriatory practices. As a consequence, neither physical nor human capital formation is likely to be adequate.

One of the lures of the evolutionary platform (Rossiiskaia 1999) is that it takes the weak state as given. It offers step-by-step remedies, although such basic ideas as transparency or the equal treatment of actors is known to presuppose an arbiter who is not himself deeply involved in a rent-extracting game of the conflicting parties. It seems doubtful whether the self-organisation of vested interests—talking about the collapse of both communism and capitalism on Russian soil—can indeed organise themselves into a new driving force, as some (*Russland* 1999) would like to see them do. Without an Archimedian point it is hard to visualise how self-enforcing vicious circles could be broken, no matter how much it would be desirable for Russian citizens and the external world alike. It seems somewhat cynical to assume that capital will "simply" return provided the conditions improve and the west stands by (*Fischer* 1999), since there is no built-in mechanism through which the much desirable turnaround in deeply-rooted disruptive tendencies could come about. The more the west is ready to accept an old hat and established mafioso of the Soviet type like Luzhkov, the more likely the self-deception and the vicious circle triggered by it will continue for many more years to come.

8. Without adding many more items to this non-exhaustive list it seems clear that the *search for an own way* is going to dominate Russian economic theory and practice for many years to come. This has a long history and is in no way restricted to the economic sphere alone: the special way and mission has always played a prominent role in Russian self-interpretation. Given that Russia has never

fitted fully either into the European or into the Asian pattern of development, this is more than understandable.

From our perspective the real depth of this cultural and paradigmatic challenge is secondary, as reference to it is likely to be instrumentalised for policies. It is simply unable and/or unwilling to address the basics of SLIP and thus create the foundations for sustainable growth. Theories of national exclusiveness prevail in all societies which have arrived at a developmental impasse. Meanwhile, among those nations which have entered the highway of economic development a striking similarity of reform issues in terms of institution-building and in the device of policy-mixes has emerged (*Buiter, Lago and Stern* 1996).

Looking from this angle, there is nothing peculiarly Hungarian in debates on pension reform, tax policies, the funding of development projects, the need to secure sufficient provision of public goods or equitable burden-sharing. These are by no means trivial questions simply to be answered by peeping into the appropriate textbook. They do pose serious challenges to economic theory and policymaking alike. This, of course, is one of the differences between the more traditional issues that emerge in countries where stabilisation or managing the debt burden are still unresolved. While the "special way" paradigm may well dominate local political discourse, from the point of view of economic theory, as well as of economic development, these remain the by-ways.

This outcome can be easily demonstrated using any number of references. While Russian economic theory focuses on something "beyond monetarism and beyond command economy", in Hungary there are no attempts to devise a specifically national model of the economy or its subsystems. Those which highlight "national paths" imply that there is a need to adjust general principles to given conditions—like an ageing population—and not to find out something fundamentally different.

An interpretative endeavour

A proper and thorough comparison of the two cases, but also a detailed exposition which contrasts a succeeding with a failing transition strategy, would require an entire monograph. However, some theoretical conclusions, even though rudimentary and preliminary, can be advanced in order to foster further reflections in the profession. It seems that remaining within the constraints set by the paradigm of economics, *both cases can be interpreted without recourse to external explanatory factors or historic/cultural determinism*.

a) Development in both cases has been obviously *path dependent*. In the Russian case this is one of the few points of consensus held by analysts. The Soviet legacy, as well as Russian traditions are of major interpretative relevance. For instance, the very fact that economic theorising and accessibility to prime sources (including previously published official documents) were severely and systematically constrained in the Soviet period, has put severe limits on the evolution of the economics profession (*Sutela and Mau* 1998) consequently, this has also put restrictions the *economic perceptions and expectations* of the public at large, including the new policymaking élite and opinion-formers.

Likewise, the determinant share of military-related industries and technologies in the overall GDP has rendered any adjustment—virtually by definition—painful, lengthy and even destructive (*Winiecki* 1991). The lack of meaningful reforms has *precluded social learning*, pertaining to such elementary items as the limits to centrally processable information, the difference between rent-seeking and profit-seeking, or the benefits of free prices, not to speak of the market valuation of assets. It is not trivial for those who have been trained in the labour theory of value, that a large smoke-screen industry can and often does have a negative asset value. This is despite (in part because of) the presence of a large quantity of concrete labour and other inputs invested in a non-marketable activity.

Thus the public perception of "privatisation as theft" is only partly explained by the much publicised pathologies of Russian privatisation. Korean or Japanese bank-industry linkages might have been as intimate as in the Russian case (*Sondhof and Mezger* 1998), yet capitalism has certainly not earned such a bad name in either countries as in Russia. The perception of equity and of what is legitimately to be expected from public authorities play a fundamental role in the way abstract economic concepts are translated into policy practice.

From this angle, the favourable educational role of the long reform period in socialist Hungary is now coming to the fore. It is not so much the progress made within the economics profession proper which matters. It is the nature of mass perceptions of what is to be expected from the state, what is the role of risk premiums on property, what is the role of entrepreneurship, and more generally the lure of non-bureaucratic careers for the bright and the young which really matters. The period of reforms served both as a training ground and as a way of proving indirectly why third road options do not work and cannot work.

From this perspective it is also important that, via reforms, tens of thousands in the state administration, in banking, in business, and in various economic sectors have acquired *practical knowledge of techniques that allow for market institutions to operate*. For instance, such skills as the way taxation is run, how bankruptcies can be turned to one's own advantage, how credits need to be screened and collaterised, how payment modes in international trade matter, or subsidies can help ailing businesses—these all constitute relevant microeconomic knowledge that no business courses can teach as efficiently as practical experience.

b) In terms of paths dependency the Russian transition has been dependent on a very backward Soviet legacy that was burdened by a self-overestimating ideology. In the case of Hungary reforms abolished the monetary overhang, created institutions of the market and also a large part of the business community, including the appearance of wealthy entrepreneurs. They also created a societal consensus across the board (except for the marginal extremes on the left and right) on the need to adopt a market economy based on private property as well as on a multi-party democracy. *Such a consensus has never existed in Russia, and if anything, it seems to be evaporating during the post-Yeltsin era.*

In Hungary the socio-economic costs of transition were seen as paying the bill for national freedom and personal prosperity, and were accepted not least because of the presence of a large irregular economy which provided a buffer for so-called "losers". In Russia, by contrast, the *internal erosion of the system had become obvious to only a small number of intellectuals, whereas the majority saw the collapse as the result of inappropriate policies*: first of Gorbachev and then also of Yeltsin. Thus reforms are seen as destructive, far above the numbers indicated by GDP and consumption expenditure data cited in the introductory section.[1] Whereas Hungarians see that a "return to Europe" is happening, the Russian political class sees transition in terms of the dismantling of the *raison d'être* the Russian state.

Societal perceptions are known to be crucial when it comes to the *sustainability* of policies. In the Hungarian case the *politicians* introducing the "wounding" reforms *were punished, while the policies proper have never been reversed*. In Russia, *policies* have frequently been *reversed, but politicians have often survived* under different banners, starting with President Yeltsin and ending up with Mayor Luzhkov. The dissimilar reaction is at least in part attributable to differences in the process of *social learning* and the thus ensuing different perceptions.

c) In the context of the present comparison it is inescapable to evoke the *geographic explanation*. According to this, it is distance from the west/the centre which really matters. Those on the "nordic rim" are close to Germany and Austria, and geography induces cultural closeness which trickles down to the economy as well.

If we remain with the comparison of transition countries, this thesis may well look plausible. However, during the last twenty-five years one of the most fundamental lessons of development economics is precisely the fact that countries with quite different backgrounds have been equally able to attain respectable results. As the seminal survey of *Waelbroek* (1998) demonstrates in detail, there has been an underlying agreement on what "good policies and good governance" have been adding up to in all corners of the world. This is what he calls the "one world consensus", implying that the same policies which are conductive to prosperity in advanced countries may work also in less developed nations. From this perspective the geographical explanation is a re-working of theories from the infancy of the history of economic thought.

[1] An extreme form of this perception is reflected in *Ellman and Kontorovich* (1997) who attribute a consciously destructive attitude to elite reformist groups.

d). *Policies matter*. While history may explain much of the social responsiveness to policies, we can also observe declining nations in history. Furthermore, our previous observation points towards the role of policies. Bringing inflation down is by and large a technical job, which can be mastered under quite different historical conditions. However, it has worked, either as a money-based or as an exchange rate-based stabilisation.

Although there is much debate about details there is no single case in which some of the basics could have been saved and inflation arrested without resorting to price adjustment, limiting the money and credit supply, balancing the budget and freeing factor and commodity prices. Following the east Asian crises there is less controversy over the role of institution-building, transparency and regulatory frames in the bringing about civilised forms of market behaviour.

One of the few consensus points with respect to diagnosing the Russian "disease" is that the latter factors have played a subordinate role in reform theories and even more so in the actual course of policymaking during the entire transition period. Therefore *the outcomes are both foreseeable and rational*; they do not prove, as *Thanner* (1999) asserts, the failure of the theoretical framework of transformation economics *in toto*. The very fact that, by and large, the same recipe could be implemented in Hungary is a counter-argument. Since we can explain Russian outcomes within the same paradigm by referring to path dependency and policy mistakes, there is no *need to rush for new theories*.

e) If we recall the exact way in which the collapse of rouble stabilisation came about, it is *hard to see any historic predetermination* in the outcomes. Was it really "inevitable" for Chernomyrdin to lose office amidst a wave of speculation against the rouble? Was it inevitable that the Duma did not adopt an elementary stabilisation package of measures in July 1998? Was it inevitable that the west would hesitate both in terms of the size and the means of channelling financial assistance to assist the Kirienko package? Was it "inevitable" for oil prices to reach a record low in 25 years just in the summer of 1998? Was it inevitable for Russia to be caught in the chain reaction between Thailand and Brazil in 1997–99? Was it inevitable that in the past three to four years, Russian oligarchs and reformers were unable to re-formulate the deal which catapulted Yeltsin to the presidency in 1996?

Unless we can answer each of these and similar questions in the affirmative, it is hard to argue against the relevance of individual and free policy choices made by varying individuals and agencies in shaping outcomes. If we do not subscribe to the shallow *post hoc ergo propter hoc* reasoning, it is hard to overlook the relevance of these and other decisions made from among the *competing options*. To cite but one: once Korea could get USD 57 bn in assistance and Brazil over USD 90 bn; however, it is hard to preclude *by definition* the technical feasibility of a Russian package of similar size, whether we endorse the policies and the economics behind it or not. In this context the USD 4.8 bn tranche of August 1998 was obviously too little too late.

f) *Foreign assistance may be harmful.* While much of the debate on Russian reform policies has been conducted ever since 1986 in terms of how the west could and should help reformers, this approach is essentially at odds with European experience, from southern Italy to eastern Germany. What we do find is the emergence of a lasting transfer-recipient entity unable and unwilling, over the decades, to change this state of affairs. This goes hand-in-hand with an ideology which is systematically rejected but which allegedly legitimates transfers. However, a precondition for this is a "Big Brother" able and willing to settle the bill.

One of the advantages of the Hungarian development pattern has been the absence of external assistance. Non-recoverable, annual and unilateral development assistance to Hungary has stagnated at around 15 DM per capita, which is a plus. This has forced the country, both in terms of structural change and in terms of social perceptions, to stand on its own feet. Since there was absolutely no chance of being financed from abroad, a vigorous adjustment and debt repayment policy could gain political consensus.

In contrast, in Russia the idea that the west (whoever this subject may denote) "has promised" Gorbachev and later Yeltsin a "compensation for withdrawal" has strongly penetrated the minds of decisionmakers. International organisations have remained unimpressed by the ongoing reporting of Russian balance of payments statistics, which have regularly recorded high surpluses ever since 1992.

Not until aid to Russia and its alleged or real misuses came up as a major item in the US electoral campaign did anybody seriously doubt that the Russian state debt needs to be resolved rather than repaid. This has allowed weak reform policies, delayed stabilisation and political corrosion; in a way it replicates what was already being seen in Central and East Europe in the 70s and the 80s.

Since food was heavily subsidised and imports centralised and redistributed through central agencies, the lure and the potential for arbitrage was great and given. It played a major role in the "original capital accumulation" in Russia. But understandably this contributed as little to the legitimacy of market institutions as did insider privatisation, political capital having been converted into business positions.

Against this background the emergence of the much despised "new Russians" is one of the few favourable developments, as these have not been exclusively recruited from the ranks of the old *nomenklatura*. Likewise the notorious role of energy monopolies in creating private wealth from public resources, or the focal role played by "authorised banks" in capital accumulation are widely known.

All of these practices have been enabled by the ongoing softness of creditor policies which readily *overdraft all the deficits that are obviously derived directly from the mismanagement of central state functions and funds*. What should have been taxed away from *Gazprom* or *Vneshtorgbank* has been readily provided by a "grandfatherish" international community. The latter has swallowed recurring breaches of various promises, both quantitative and institutional. Once opportunistic behaviour pays better than law-abiding behaviour, the former will spread.

g) By comparing the Russian and Hungarian transformations some *new insights into modern economic theory can be given empirical backing*. For instance, the role of *social intangibles* against the earlier dominant physical factor/growth theoretical approach can be highlighted. *Social learning* could be shown to be more important than any optimal design of institutions or any ideal policy mix at a given point of time. Stressing the role of institutions and governance does not invalidate the need for *sound macropolicies*. Moreover, the final conclusion might well be just the opposite to what *Cohen* (1999) recently suggested. Transition economics is not Sovietology without Russia, but it embeds the peculiar Russian case in a *broader comparative perspective*. From this angle we can see that no transition can succeed without Russia, but the peculiar Russian case needs to be embedded in a broader comparative perspective. Thus it is clear that *no transition can succeed without having first mastered SLIP*. Therefore it is hard to believe that just Russia could and should avoid the pains inherent in this option. On the contrary: against this broader background it is hard to know how *little has been accomplished* in reality—as against pronouncements of intent—*in reshaping the lethal institutional and mental legacy of the Soviet period*. The latter was much weaker in Hungary and thus its consequences have been easier to overcome.

The real gain from this neoinstitutionalist approach for country studies is that it allows for an *endogenising of capital formation*, both physical and human. By the same token, it allows for the establishment of the missing link between the ways accumulation comes about and its *being transferred into investment* and explaining longer run *growth perspectives*. The latter are shown to be permanently different and there is a technically solid explanation for this.

All in all, reference to the role of history and institutions does not need to be instrumentalised into a defence of poor policies. On the contrary, it may well explain *why some societies might be more open to standard models than others, whereas the workings of these models remain largely the same the world over*. What is more, the big or final questions, such as whether policies form institutions or institutions shape policies or both, remain open for further reflection.

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ADJUSTMENT STRATEGIES OF HUNGARIAN INDUSTRIAL FIRMS IN THE 1990s[1]

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This study examines the adjustment strategies of Hungarian industrial firms during the transition period. Using the panel survey of a representative sample of Hungarian industrial firms, it aims to investigate Laki's theory concerning the corporate strategies of companies during the postsocialist transition. Moreover, it tries to capture some important features of the changes which have occurred during the nineties using the terminology and logic of this theory. The survey evidence from 1993 and 1998 reinforces (or, at least, does not falsify) the kernel of the theory on corporate strategies. Furthermore, the data of recent years show that the behavioural patterns prevailing in market economies have become widespread among Hungarian companies.

Introduction

Recently, many studies have been published on the issue of adjustment strategies of Hungarian companies during the transition period (*Adorján et al* 1996; *Antal Mokos and Kovács* 1998; *Balaton* 1994; *Carlin et al* 1995; *Hoványi* 1995a; *Laki* 1992, 1993, 1994a, 1994b; *Szanyi* 1998; *Török* 1993, 1994; *Voszka* 1996; *Whitley et al* 1995). However, these researches have used different scientific approaches. Yet apart from the relevant differences, they have some features in common. The analyses in question were based upon case studies or macrostatistical databases (an exemption: Antal Mokos and Kovács 1998), and they concentrated on larger companies.

The panel survey of industrial firms, compiled by the Department of Sociology of the BUES, gives us the opportunity to widen the framework of the investigation of the corporate behaviour of firms.[2] The survey considers integrated firms of all sizes. Furthermore, it provides a representative sample of the target population (although the research extends only to manufacturing enterprises).

This study analyses the adjustment strategies of the companies in the first decade of the transition to a market economy. The terminology used below, and

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[1] This study is a part of the research programme "Longitudinal Analysis of Industrial Firms" carried out in the Department of Sociology of the Budapest University of Economic Sciences (BUES). The research programme was supported by the Hungarian Scientific Research Foundation (OTKA) and by the Research Support Scheme (RSS). Comments by György Lengyel were greatly appreciated, but the author is entirely responsible for the contents of the study.

[2] Among the recent studies of the research programme see: *Balázs* (1998), *Lengyel* (1997, 1998), *Tóth* (1998).

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the hypotheses examined here, were developed by Laki (1992, 1993, 1994a, 1994b); his results are based on case studies carried out in the first half of the 1990s. The aim here is to test the relevance of the terminology using factor analysis. An examination is also made of the changes in corporate strategies during the 1990s using this terminology by analysing the evidence for the years 1993 and 1998. Laki's classification of the strategies is based on very fundamental features of corporate behaviour. This study does not go into further details with regard to these features.[3] The strategy-building process is not included here.[4]

At the present state of this research a formal model of the theory cannot be provided. Thus, our hypotheses lack the determination of the exact characteristics of the relationships between the various elements of corporate behaviour. Hence, the empirical evidence presented below does not verify or falsify any one of the statements of Laki's theory. Instead, we try to make the first steps towards an exact explication and testing of what appears to be a very relevant theory.

Laki's model

In his research, Laki investigated certain characteristic measures of management in order to find out more about the transitional recession. He discerned two groups of activities. In the first, some decisions may lead to a solution of a crisis, at least in the long run. Other steps could, at best, only delay the deepening of a crisis. Activities in this second group give management the opportunity to help the firm recover, but at the same time, these measures could also deepen a crisis.

This very basic classification is derived partly from assessments provided by managers of the firms examined in Laki's case studies. The particular situation of the companies and the personal experiences and attitudes of the managers questioned contributed to the evaluation of the activities examined. Nevertheless, it was possible to create a well-defined partition of the sets of activities based on a majority opinion.

The activities which seem to promote a fast solution to a crisis are the following: price increase, product change, sales improvement, development of capacities, organisational restructuring, increase in market share, market change, and cost reductions. The measures which appear to delay the outbreak of a serious crisis are: delays in paying business partners, delay or non-payment of taxes, stock production, redundancies, the selling of assets, the renting of assets.

[3] For a detailed classification of the strategies see Antal Mokos and Kovács (1998).

[4] This issue should not be ignored by economic-sociological research. An analysis of the strategy-building process from the point of view of management science can be found in *Balaton* (1998).

Among the activities mentioned above there are two whose position in the classification is derived from the special characteristics of the transition economy. The position of redundancies among the measures of the delaying strategy is due to the historical situation. In a typical market economy this phenomenon is a part of a solution strategy, but in the first years of transition managers tried to avoid redundancies for political reasons (even if it would have clearly resulted in the better performance of the company). In market economies the activity of selling assets is usually part of a restructuring strategy leading to the solution of a crisis. However, most companies in transition economies adopt this kind of measure to raise revenues from the asset sale in order to solve short-run insolvency problems.

Table 1

Activities belonging to different strategies

Solution strategy	Solution in market economies Delaying in transition economies	Delaying strategy
Price increases		Renting estates
Change of products	Redundancy	
Sales improvement		Delays: social security contributions
Development of capacities		Delays: taxes
Market change	Selling assets	Delays: business partners
Cost reduction		Delays: banks
Reduction of stocks		
Organisational restructuring		Production to stock

Managers in a crisis situation, understandably, prefer to adopt the solution strategy. However, the constraints of the decisions do not always allow them to chose this alternative. Adopting the delaying strategy is a forced choice brought about by the lack of a real chance for a quick solution (although it is possible that the managers do not have the appropriate means for delaying, either).

According to the interpretation here of Laki's theory, there are three types of background conditions behind the strategy selection of firms. The first type contains different sources: economic and human capital, market power, etc. If any of the two strategies is chosen, the use of these reserves may lead to the recovery of a company in crisis. The second type of factors determining corporate behaviour focuses on provisional developments in relevant markets. The bigger the chance for a positive shift in demand, the more favourable the conditions for adopting the solution strategy. The third group of determining characteristics comprises the personal skills and attitudes of corporate leaders. Risk-taking actors, as well as those thinking in the long-run, are (*ceteris paribus*) more likely to adopt measures belonging to the solution strategy.

Accepting these propositions, and adding some further assumptions about the historical development of the background conditions in the 1990s, three hypotheses can be composed and these are examined below.

Our first hypothesis concerns the relationships between the measures. Under certain market conditions, and with certain amounts and types of sources, the selection of one or the other strategy may mean the adoption of several measures belonging to the strategy chosen and favoured by the circumstances given. If the sufficient conditions necessary for taking certain steps belonging to one strategy are present, then these conditions can also foster other activities belonging to the same strategy. Thus it can be supposed that there are stochastic relationships between the different activities belonging to a particular strategy. However, it is not assumed here that the adoption of all possible measures of a strategy are correlated with each other. There are different types of conditions, which are favourable for only some of the activities belonging to a strategy.

Theoretically, the two strategies are interpreted as alternative outcomes of a managerial decision. However, the complexity of real world situations means that one cannot pretend that adopting an activity from one group excludes choosing measures from another. According to the second hypothesis, a negative stochastic relationship is assumed to exist between the activities belonging to different strategies.[5]

The radical and fast changes of legislative and market conditions of economic organisations during the first half of the 1990s put pressure on managers to reshape their strategies. In the Hungarian model of the socialist economy, a more market-oriented management culture had gained ground in enterprises. Hence, the relatively independent managers were able to adopt (economically) more effective production and marketing policies. After 1989, their task was not only to modify the production structure and marketing strategies. The managers' toolkit for reshaping certain aspects of production also had altered. The relevance of experiences accumulated during the socialist economy had diminished in the new era. Despite these changes, the strategies adopted by the managers were inevitably built upon their earlier experiences, although the selection mechanism of the market forced them to develop new, more suitable answers to survive under the new circumstances. Attention here has been focused on the changes in the characteristics can be made to the strategies during the 1990s. Adding some new evidence, an examination was carried out of the contribution to the research programme investigating the impact of the relatively decentralised Hungarian socialist economic system on the development of the market economy after 1989.

The speed of adjustment of the economic actors in post-socialist societies is an issue which has been widely discussed in the literature (Laki 1994a, pp. 7–8).

[5] Remember that apart from these two possibilities, managers can decide not to choose any of the two crisis strategies. Hence, in this model the firm has three alternatives in a crisis.

Most scholars agree that, in the first few years, the typical characteristics of corporate behaviour were closer to the ones experienced in the past than to the features prevalent in market economies. The companies were characterised by hesitation or by returning to the behaviour patterns of the eighties (Laki 1992, 1993, 1994a, 1994b; Török 1994; Hoványi 1995a; Voszka 1996; Szanyi 1998). The studies found different causes behind this phenomenon. Sufficient knowledge had not been accumulated in the new era. Moreover, at the time of radical changes, there was no room for long-term planning; therefore the possible new patterns of strategic behaviour were out of focus (Laki 1994a, p. 13). The transitional recession (*Kornai* 1993) also had a special impact on corporate crises (Hoványi 1995a). Under these circumstances, strategy-building was strictly constrained.

Some researchers have described the passive behaviour adopted by most companies as a conscious survival strategy (Török 1994). *Grosfeld and Roland* (1995) defined two phases of adjustment. The first period of passivity was followed by new offensive strategies (after the actors realised that they had expected state intervention in vain). Other authors blame managers for the lack of an offensive behaviour (Hoványi 1995b). In the second half of the 1990s new results were published and these indicated that the learning and defensive period of the Hungarian industrial sector had ended (*Szalai* 1997; *Kovách and Csite* 1999).[6]

In the model it is accepted by the study that the inherited features of corporate strategies gradually disappear while, in the behaviour adopted, more and more enterprises are dominated by characteristics prevailing in the market economies. Thus, our third hypothesis states that the activities belonging to the delaying strategy in the first half of the 1990s (as a legacy of the past), tend to be parts of the solution strategy.

The relevance of Laki's model (described above) is examined here using factor analysis. The variables measured are management measures, and the factors sought for represent the various dimensions of strategic activity. While no comprehensive classification of background conditions has as yet appeared and although there is no complex casual model of the relationships between conditions and activities, an exact formulation of the supposed structure of the variables is impossible. The evidence offered by the explorative factor analyses for 1993 and 1998 respectively, illustrate the relevant background conditions and causal relationships for model building.

Our presumptions (derived from the theory and from some other assumptions) can be summarised in terms of the factor model in the following way: a) activities strongly related to one factor (in the same direction—positive or negative) should belong to the same strategy; b) at least some factors are expected to be

[6]According to a radically different view of the transition, it is misleading to compare the characteristics of transition economies with those of an ideal market economy, inasmuch as the former might gradually be getting closer to the latter (*Grabher and Stark* 1996).

bipolar: the adoption of some measures of one strategy diminishes the likelihood of steps in accordance with another strategy, c) the redundancy and the asset sale represent parts of delaying factors implemented in the first half of the 1990s and belonging to solution factors at the end of the decade.

Data and measurement

The panel survey research programme for industrial firms provides a representative sample of Hungarian manufacturing enterprises of all sizes. In the research programme a statistical survey was carried out for every year between 1992 and 1998. While the follow-up of the firms surveyed could not be perfect, the longitudinal analyses were constrained.[7] In other words, the samples represent the populations of companies for each year, and thus the cross-sectional data provide reliable evidence. The sample size in 1993 was 499, and in 1998 it was 421.

In the surveys here managers were asked about the measures mentioned earlier. They had to assess how strongly a certain activity characterised the past year.[8] Hence, the basis of the analysis was in fact a subjective evaluation of managers. Certain features of this method can be criticised. For example, the distribution of answers in terms of real activities cannot be interpreted. Besides, in such cases ad hoc answers are more likely.

The alternative method for seeking measurable indicators of the corporate behaviour objectively also has serious deficiencies. With respect to answering delicate questions (for example, about tax avoidance), the more exact the question is, the more biased the answer gets because of the efforts to avoid the uneasy consequences of telling the truth. A five-grade scale gives the respondent the opportunity to avoid lies, yet without confessing the painful truth. On the other hand, gathering objective data from managers leaves the researcher with the difficult task of evaluating the relevance of activities in a particular situation. The researcher does not know much about the specific circumstances under which the decisions were made. Therefore, it seems less problematic to use subjective evaluations of the activities. The variables examined here were measured with an ordinal scale. Hence, they do not fit the factor model. Therefore, dichotomous variables were created. Although methodological problems were solved in this way, some information in the answers was lost. Thus, more informative and less reliable original gradings were also used.

[7] The unavoidable imperfect panel sampling not only limits the validity of the longitudinal analysis of the survivors, but as a panel, it makes the comparison of samples in different years impossible (i.e. comparison as independent samples).

[8] There were five categories offered: 1. This activity did not characterise the behaviour of the firm at all. 2. It was rare. 3. It was sometimes present. 4. The activity characterised the behaviour of the firm. 5. The activity strongly characterised the firm's behaviour.

Results

The factor analyses based on the data for the first half of the 1990s tend to reinforce Laki's classification. The statistical method made it possible to explain more thoroughly some hypotheses in a more sophisticated way. However, some modifications are also necessary. There are five factors with eigenvalues over one in the various factor outputs, and 50–60 percent of the total variance is explained by these factors. There are no bipolar factors. Hence, there is no evident sign of a negative relationship between the two strategies.

The first factor belonging to the delaying strategy contains the non-payments of liabilities. Another supposedly delaying factor has a strong relationship with the renting and selling of assets. Redundancies do not belong to any of the delaying factors. Instead they have a relationship with some solution activities. The production of stock also correlates with measures for the solution strategy, not with the delaying ones.

The set of measures supposedly belonging to the solution strategy is more heterogeneous. Cost reduction, the reduction of stocks and restructuring are correlated with one another and with redundancies. In the factor model, using the original answers, the weak changing of the market relates to these activities. Another factor contains investment and sales improvement, and in the model of dichotomous variables it also contains market change. The former two activities have (albeit a not very strong) negative relationship with redundancy. Price increases and stock production are correlated. The presence of these two activities increases the probability of product change in the model of original variables.

One important result of the factor analysis was that the two strategies turned out to be not purely alternative choices, excluding each other. Activities aimed at solving the crisis can meet a delaying corporate policy. The delaying strategy has two independent elements: non-payment of liabilities and the selling or renting of assets. However, the factor of asset-selling or renting is independent of all other activities, and its supposed position is derived from the special characteristics of the transition; thus it can be a part of the solution strategy as well, as part of the set of delaying activities. While the empirical evidence does not falsify it, we accepted our initial assumptions based on Laki's classification; this takes into account the particular effects of the historical background.

The solution strategy has three groups of measures. The first group contains activities requiring market success (e.g. investment, sales improvement). In the second group there are measures belonging to a production or market offensive (e.g. price increase, market change). The third group is composed of the reactions leading to saving. Among the three elements mentioned here, only the last one characterises a crisis strategy.

According to the data for the first half of the 1990s, stock production, a supposedly delaying activity, belonged to the category of price increase and also

Table 2

Factor results: data for 1993. The original variables

Principal components analysis, initial statistics

Factor	Eigenvalue	Percentage of variance	Cumulative percentage of variance
1	3.48064	21.8	21.8
2	2.15411	13.5	35.2
3	1.53533	9.6	44.8
4	1.12703	7.0	51.9
5	1.05707	6.6	58.5

Rotated Factor Matrix (varimax rotation)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5
Price increases	−0.12036	0.23284	−0.17063	0.44570	−0.22922
Product change	0.13074	0.24676	0.28484	0.56929	0.01058
Sales improvement	−0.15582	0.16158	0.70109	0.03378	−0.08432
Development of capacities	−0.01425	−0.09925	0.78077	0.00306	0.02730
Market change	0.16387	0.42592	0.36785	0.47654	0.01050
Cost reduction	0.05798	0.79175	0.06126	−0.01501	−0.02979
Reduction of stocks	0.04491	0.75073	−0.06172	0.05551	0.13158
Organisational restructuring	0.08353	0.54338	0.08861	0.30557	0.24186
Stock production	0.05850	−0.14453	−0.09940	0.77807	0.14608
Redundancy	0.26782	0.42159	−0.40197	0.11609	0.31357
Renting estates	0.09242	0.03296	0.04491	0.01932	0.80835
Selling assets	0.09967	0.19968	−0.13848	0.01398	0.70563
Delays: social security contributions	0.89265	−0.00088	−0.04451	0.07396	0.05956
Delays: taxes	0.87105	0.01096	−0.08310	0.03253	0.09843
Delays: business partners	0.77365	0.06591	−0.00014	0.09794	0.01058
Delays: banks	0.65064	0.17446	−0.07558	−0.05151	0.13521

to product change—both regarded as solution strategy measures. Moreover, even in 1993 redundancies had a role different from the one supposed. Redundancies appeared together with other solution strategies. However, at the same time, in the factor model of the original variables, redundancy has a negative relationship with investment and sales improvement—thus to a certain extent reinforcing Laki's statement about the intentions of managers not to dismiss unless it is unavoidable.

At the end of the decade, the relationships between activities and strategies had changed. More characteristics of the behaviour of managers were similar to those prevalent in market economies than they had been before.

There are six factors with eigenvalues over one in the different analyses. These factors explain 60 percent of the total variance. Three factors have approximately

Table 3

Factor results: data for 1993. Dichotomous variables

Principal components analysis, initial statistics

Factor	Eigenvalue	Percentage of variance	Cumulative percentage of variance
1	2.82647	17.7	17.7
2	1.79745	11.2	28.9
3	1.61998	10.1	39.0
4	1.20286	7.5	46.5
5	1.04612	6.5	53.1

Rotated Factor Matrix (varimax rotation)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5
Price increases	−0.11356	0.04936	−0.21579	−0.01474	0.72569
Product change	0.10293	0.34251	0.43614	−0.24181	0.06617
Sales improvement	−0.16783	−0.03793	0.64798	−0.05251	−0.02588
Development of capacities	0.01904	−0.26466	0.67159	0.09904	0.21512
Market change	0.00432	0.25779	0.57461	0.07884	0.30089
Cost reduction	0.01795	0.64428	0.02447	−0.04300	−0.07012
Reduction of stocks	−0.01798	0.65901	−0.06359	0.14227	−0.03941
Organisational restructuring	0.05906	0.57806	0.25409	0.14183	0.14893
Stock production	0.18536	−0.12725	0.28370	−0.00573	0.61509
Redundancy	0.23670	0.59665	−0.17480	0.10569	−0.01548
Renting estates	0.12126	0.02914	0.07173	0.78844	−0.14001
Selling assets	0.07330	0.22984	−0.07493	0.71077	0.14695
Delays: social security contributions	0.89660	0.07788	−0.00779	−0.02047	0.00089
Delays: taxes	0.88552	0.05682	−0.04756	−0.05519	0.04329
Delays: business partners	0.67455	0.00238	0.02349	0.10829	0.07702
Delays: banks	0.56906	0.11300	−0.06903	0.17209	−0.08032

the same composition as they had in 1993. The first is the non-payment factor, although there is a significant difference which is worth noting. Non-payment of taxes has a weaker relationship with indebtedness in the market. The second, relatively unchanged factor, is the one concerning investments and sales improvement. Moreover, stock production goes together with price increases, as it did before. The composition of other factors were reshaped between 1993 and 1998.

The factor of asset selling (or renting) can no longer be considered as an independent delaying strategy group. The renting of property is an independent factor in itself. The most important factor of crisis resolution has been transformed. In place of market change, the selling of assets has become a part of it. Moreover, in the model of the original variables, the position of redundancy in this solution activity group has became stronger since 1993. The market change in 1998 appears together with the product change.

Table 4

Factor results: data for 1998. The original variables
Principal components analysis, initial statistics

Factor	Eigenvalue	Percentage of variance	Cumulative percentage of variance
1	2.93510	18.3	18.3
2	2.28120	14.3	32.6
3	1.64617	10.3	42.9
4	1.16614	7.3	50.2
5	1.05621	6.6	56.8
6	1.02100	6.4	63.2

Rotated Factor Matrix (varimax rotation)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6
Price increases	−0.01054	0.06028	0.34930	−0.12667	0.05175	0.69614
Product change	0.16340	−0.01101	0.12452	0.81113	−0.13359	0.13359
Sales improvement	−0.05087	−0.04194	0.79720	0.18293	−0.06929	−0.06036
Development of capacities	0.04556	−0.02584	0.76571	0.10911	0.03764	0.12222
Market change	0.06910	−0.02228	0.15690	0.84813	0.20199	−0.01688
Cost reduction	0.66055	0.04488	0.14804	0.14367	0.05815	0.14694
Reduction of stocks	0.71635	0.10280	0.09236	0.05847	0.29633	0.05954
Organisational restructuring	0.55800	0.06673	0.25415	0.28692	−0.11980	−0.03472
Stock production	0.07878	−0.02516	−0.19808	0.24487	−0.04505	0.75136
Redundancy	0.64421	0.13531	−0.31484	0.11355	−0.05921	0.05984
Renting estates	0.11911	−0.01048	−0.07230	0.08748	0.85057	−0.04555
Selling assets	0.65639	0.03619	−0.20328	−0.14976	0.06850	−0.14686
Delays: social security contributions	0.15081	0.87274	−0.10677	−0.00430	−0.07786	−0.01416
Delays: taxes	0.01736	0.85381	−0.16395	0.04340	−0.07184	0.10225
Delays: business partner	0.06436	0.54520	0.10022	0.02709	0.51312	0.13473
Delays: banks	0.08842	0.57319	0.12212	−0.06636	0.14823	−0.08649

The "toolkit" of the delaying strategy has been diminished slightly. Property lending and the non-payment of liabilities are the parts of this. Among the activities of indebtedness, the non-payment of taxes is the one most often adopted. The steps of the solution strategy have become clear-cut. The selling of the assets has become a means of restructuring. The means of market offensives are divided and price policy is separated from production policy.

Table 5

Factor results: data for 1998. Dichotomous variables

Principal components analysis, initial statistics

Factor	Eigenvalue	Percentage of variance	Cumulative percentage of variance
1	2.41449	15.1	15.1
2	1.94270	12.1	27.2
3	1.59629	10.0	37.2
4	1.26010	7.9	45.1
5	1.10360	6.9	52.0
6	1.04639	6.5	58.5

Rotated Factor Matrix (varimax rotation)

Variables	Factor 1	Factor 2	Factor 3	Factor 4	Factor 5	Factor 6
Price increases	0.10756	−0.09384	0.17961	0.00955	0.72897	0.29281
Product change	−0.04413	0.09206	0.09462	0.75779	0.23880	−0.02116
Sales improvement	−0.00847	−0.03991	0.75733	0.11355	0.00133	−0.00055
Development of capacities	−0.03139	0.06144	0.81586	0.05112	0.02569	−0.05085
Market change	−0.00037	0.02010	0.06838	0.83619	−0.17180	0.03778
Cost reduction	0.04190	0.68574	0.23198	−0.04151	−0.11514	−0.10841
Reduction of stocks	0.17126	0.67716	0.02375	0.02047	−0.11339	0.28555
Organisational restructuring	0.06395	0.50931	0.21631	0.28852	0.07207	−0.05229
Stock production	−0.04899	0.10561	−0.10651	0.03736	0.66670	−0.21299
Redundancy	0.10264	0.60783	−0.20257	0.05921	0.19073	−0.20522
Renting estates	−0.01992	0.06189	−0.08052	0.02041	0.00644	0.80304
Selling assets	−0.09012	0.61544	−0.21603	−0.01163	0.06471	0.18517
Delays: social security contributions	0.80506	0.14795	−0.11567	−0.00161	0.08450	−0.20569
Delays: taxes	0.82569	−0.02133	−0.14020	0.03872	0.12862	−0.17110
Delays: business partner	0.60757	−0.01435	0.09013	−0.07728	−0.00797	0.31974
Delays: banks	0.59004	0.09255	0.09372	−0.00553	−0.11900	0.10444

The evidence of the factor analyses mainly reinforces the statement of the first hypothesis. If we take into account the ambiguous position of redundancy and asset selling, it is true that activities related to one factor belong to the same strategy (the only exemption is the stock production). Data for 1998 support the third hypothesis about the directions of changes of corporate behaviour during the transition period. Activities with special positions in the transition economy (such as redundancy and asset sale) are becoming related more strongly to the solution strategy. However, the evidence suggests no negative relationship between the adoption of delaying and solution strategies.

Discussion

This study has examined the adjustment strategies adopted by Hungarian companies during the transition period. It has attempted to investigate a survey sample with reference to Laki's theory of the corporate strategies of companies in the post-socialist economy. Moreover, it has tried to capture some important features of the changes during the nineties using the terminology and logic of Laki's theory.

Laki examined corporate strategies in the years before, and just after the beginning of the transition. Referring to the theoretical literature and to his own empirical research, he defined the activities that may be regarded as the reactions of management to crisis situations, and he interpreted them as means of various corporate strategies. He differentiated two types of strategy: one served long-term recovery and the other delayed imminent bankruptcy. Laki took into account the impact of the legacy of the socialist system on corporate behaviour, and showed that some of the activities belonging to the solution strategy in market economies were avoided or were used only for delay in Hungary. However, it has been suggested here that the strategies of the companies tend to be more similar to the ones prevailing in market economies.

In order to explore the structure (and the changes in the structure) of the activity set, factor analyses were carried out using survey data from 1993 and 1998. The surveys of those years reinforced, or at least did not falsify the kernel of the theory on corporate strategies. Moreover, the data of recent years show that the behavioural patterns of market economies have become widespread among Hungarian managers. According to Laki's studies, there were two activities which, in the first half of the 1990s, served as a delaying strategy; however, in a market economy these are in fact part of a solution strategy namely the sale of assets and redundancy. Redundancy was applied as a part of a solution strategy even in 1993. Nevertheless, it was clear that firms with good perspectives avoided this option. Yet five years later the situation had changed. The sale of assets had been built into the solution strategy.

However, the statistical survey evidence does not support the theory with respect to the interpretation of strategy selection. While in Laki's model the strategies seem to be alternative choices, our data show the two strategies to be independent. A significant number of firms have adopted measures from both strategies at the same time.

This study lacks the formal treatment and exact testing of the theory investigated, although the author is convinced that the basic inventions of the model are worthy of a more sophisticated explanation in the theoretical framework of choice. No doubt, more detailed analyses will appear in the future.

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HOW DO MANAGERS INTERPRET ECONOMIC SUCCESS?

(Some experiences from an empirical investigation)

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On the basis of an empirical survey this study attempts to find out if managers think about their enterprises as being succesful, and how they interpret or measure the success of the enterprise. Furthermore, it investigates what managers regard as the main problems of the economy and their own enterprises, and also the connection between the perception of these issues and data which describe the real conditions of the enterprises.

In the first half of the nineties economic sociologists usually explained the behaviour of enterprises by referring to traditions in the institutional environment, and to uncertainty generated by the disruption of these traditions. (*Stark* 1994, *Bunce and Csanádi* 1993) Although any examination of the influence of the institutional environment is a seemingly worthwhile exercise (*Kornai* 1993), relatively few empirical surveys have been conducted to explore this particular area. Most of the investigations that have been carried out have relied on secondary analyses (*Laki* 1992, 1993), case studies (*Whitley et al.* 1996) or small-sample surveys (*Török* 1993).

Another line of inquiry has focussed on the learning process of enterprises and the reconstruction of the attitudes of intra-enterprise economic actors (*Swaan* 1994, *Csontos* 1994, *Janky* 1996, *Fogarassy and Szántó* 1996, *Szanyi* 1993). The analyses revealed that the interpretation of enterprise success involved several uncertain factors (*Major* 1995, *Lengyel* 1993, *Rózsahegyi* 1996).

The enterprise panel research included questions about enterprise success and failure, and the main problems of enterprises and the economy, as seen by enterprise managers. What follows is a summary of the conclusions relevant for this subject. The sample contains weighted data for 1993 with reference to 540 manufacturing enterprises.[1] (*Balázs* 1993)

[1]The investigation was carried out by the Department of Sociology and Social Policy of the Budapest University of Economic Sciences, in collaboration with OMK (National Labour Center). It was supervised by János Balázs and the author and supported by OTKA (National Science Research Fund) and RSS (Research Support Scheme of the Open Society Foundation).

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Enterprise successes and problems

Less than half of the 540 directors of the enterprises in the sample—i.e. 44 percent—deemed their firms successful while 56 percent regarded their business as unsuccessful. 14 percent qualified their enterprises clearly as being failures, 42 percent felt that their firms were having mixed fortunes.

This ambivalence with respect to the difficulty in defining enterprise success, as well as the complexity of subjective judgements, were also reflected in the answers given by leaders when they expressed *the criteria they used for rating the success of their firms*. In the first analysis, the replies to the open questions could be ranged in eight groups. They included profit and liquidity, growth of turnover, increases in orders and in exports, enterprise development, stability or extension of business relations, and improvement in professional standards.

The answers presented quite a broad range of opinions; however, in the second analysis the responses were broken down into three groups. Profit margin outlines one unambiguous group, liquidity another (with the reservation that the actual functioning of the firm and the assessment of the situation are directly correlated) and finally, the broad umbrella of growth, and expansion. Since the managers could give more than one answer, it was found that most named profit (37 percent) in first place, one-third (33 percent) named liquidity, and the remaining 30 percent named growth and expansion, (i.e. the improvement and dynamism of the business).

The somewhat different question—namely, *what kind of enterprise behaviour is likely to bring success?*—elicited an even wider variety of answers. In first place most enterprise managers mentioned market and consumer-orientation, alongside correct behaviour. Significant mention was made of innovative, multiple strategies which satisfy high quality requirements. The above factors comprised nearly three-quarters of the first answers given. There was, however, another and far from negligible proportion of answers that declared quite different aspects as signs of enterprise success: either being aggressive and even incorrect, or working primarily for survival with external support.

In the spontaneous economic organizations of a market economy—as Coleman explains along the lines of Hayek's thinking—partners are mutually interested in maintaining business relationships, given that such relations are symmetrical. These relations and the underlying behavioural patterns are in contrast to the corresponding features of constructed organizations. In the latter, at least one partner is not interested in maintaining the relationship and therefore external constraints are required (*Coleman* 1991). In view of this distinction—which is in accord with Weber's and Granovetter's concept of the motive of limited profit—one may differentiate market-oriented and non-market oriented behavioural patterns in the managers' answers with respect to successful enterprise behaviour.

As for the problems of the enterprise and those of the economy as a whole, the answers (again given to open questions) partly overlapped, but there were significant differences and shifts of emphasis as well. The *greatest problems facing individual enterprise* were seen as being drop in demand and lack of capital—these factors accounted for nearly two-thirds of enterprise problems. After the contraction of the rest of the eighteen kinds of answer into broader categories, it was found that about one-eighth of the respondents blamed some shortage—e.g. specialists, material or modern technology—as problems. A similar proportion mentioned excessive taxation, rising costs, defects and incessant changes in the institutional environment. Only 5 percent of leaders declared that their firms had no problems, and a similar proportion mentioned that they had liquidity problems.

The *main problems of the macroeconomy* were judged by a variety of criteria. The twenty-six criteria are partly in accordance with what was found at enterprise level; however, at the macro-level the decrease in demand and lack of capital were mentioned by only two-fifths of the respondents. Similarly, a substantially lower proportion (4 percent) pointed to shortages as economic problems. In contrast, a larger number of the respondents blamed the unstable legal system and property relations for their difficulties. They also cited taxation, inflation, mistakes in the banking system, and economic policy as factors causing problems. Although corruption was seen to be the main problem by a relatively low number of respondents at both macro- and micro-level, there were differences. 1 percent mentioned it as a major problem at enterprise level and 6 percent as a general economic problem. In this case similarities, unlike deviations, do not require explanations.

There are two probable causes underlying the deviation and shift of emphasis between the perception of enterprise problems and complications in the economy—notably, that lack of demand and funds comprise the main problem at enterprise level while the faults of institutions and economic policy-makers are blamed for the negative features of the economy. One reason for this must be sought in the different levels of interpretation. When considering the central problems of the Hungarian economy, firm managers do not merely look at the concerns which they presume are hitting all other firms—they also take into account the inter- and supra-enterprise relations, macroeconomic institutions and the decision-makers of economic policy. The other reason must be in connection with the differences in communication channels and experiences. Similarly to the formation of the opinions of the population (*Angelusz* 1996), there appears to be a difference between the information bases of the two levels. While first-hand experience motivates company managers in thinking about company-level problems, they rely more heavily on sources in the mass media when forming views about the whole economy. As a result, they regard the problems originating from taxation, inflation, and the deficiencies of the banking system as being harder at the macro-level than their experiences with their own firms would justify.

Correlation between variables

The assessment of the efficiency of a firm does not show any significant correlation with size of staff, type of ownership (private or state) or geographical location; however, foreign ownership shows a slight positive effect: as against the average 44 percent, 56 percent of foreign-owned firms claimed to be successful.

Whether managers regard their firms as successful or not is logically correlated with their profits.

Table 1

Perception of success, with respect to profitability of the firm

does it produce profit?	do you assess your firm as successful?		
	not successful	successful	
no profit	198	111	309
	64.2	35.8	61.8
	70.2	50.9	
has profit	84	107	191
	44.0	56.0	38.2
	29.8	49.1	
	282	218	500
	56.5	43.5	100.0

n. a.: 40

The correlation is statistically significant, but not strong: two-thirds of firms making no profit regard themselves as unsuccessful, while over half of the profit-making companies claim they are successful. As can be seen, half the enterprises that see themselves as successful make profit and the other half do not. This is linked to the fact that there is a strong correlation between the measurement of success and the assessment of a firm's efficiency, whereas there is weak correlation between profitability and the measurement of success.

It was typical that most of the managers of allegedly successful enterprises were not the ones who measured success by profit but who regarded growth or expansion as the main gauge of success. Both the managers who looked upon profit, and those who also deemed liquidity to be a central criterion of success were below average with respect to the number declaring their firms successful.

Among those who cite profit as the main criterion of a firm's success the truly lucrative enterprises are weakly overrepresented, while among those who place the preservation of liquidity in first place, the proportion of lucrative firms is average. In contrast, companies that consider growth as the chief index of efficiency recorded below average profits.

To sum up, it can be established that the *enterprises that assess their efficiency in other than financial terms regard themselves as successful at an above*

Table 2

Means of measuring success, and the evaluation of the success of a firm

what is the gauge of success?	do you find your firm successful?		
	not successful	successful	
profit	98	65	163
	60.2	39.8	36.8
	40.6	32.2	
liquidity	89	60	148
	59.7	40.3	33.5
	36.7	29.6	
expansion	55	77	132
	41.7	40.3	29.8
	22.7	38.1	
	241	201	443
	54.5	45.5	100.0

n. a.: 97

Table 3

Means of measuring success, and the profitability of the firm

what is the criterion of success?	profitability		
	not profitable	profitable	
profit	94	72	166
	56.8	43.2	37.1
	34.3	41.5	
liquidity	92	58	150
	61.4	38.6	33.5
	33.5	33.5	
growth	89	43	132
	67.2	32.8	29.5
	32.3	25.0	
	275	173	447
	61.4	38.6	100.0

n. a.: 93

average rate, whereas they make below average profits. Thus, our hypothesis—that thinking about profit and making profit are strongly correlated—has been disproved. When, however, the focus of interest is on the *firms that regard themselves as clearly unsuccessful*, one finds that substantially more than the average—over half—*tend to gauge success by profits*.

The choice of the criterion by which they judge success was not correlated with ownership (state or private, or foreign). Similarly, the size of the enterprise had a statistically negligible influence on the management's perception success. It is, however, remarkable that while an average two-thirds of the firms use liquidity as the central gauge for measuring success, this applies to over 45 percent of firms with more than 300 employees.

As was mentioned above, some three-quarters of the firms regard correct, market- or customer-oriented, and innovative and strategic behaviour—that is, a market-related characteristics—as the main precondition for a successful enterprise. The other one-quarter, of managers, however, claim that success can be expected by firms that are aggressive, devious, incorrect or which are set up to survive through the receipt of subsidies. Slightly overrepresented among the self-reportedly successful firms are those who link success to market criteria, yet the correlation is not strong.

Table 4

What firm behaviour can hope to be successful in relation to self-reported efficiency?

is the firm successful?	what behaviour will be successful?		
	market-oriented	non-market oriented	
not successful	166 70.6 51.0	69 29.4 62.5	235 53.9
successful	159 79.3 49.0	42 20.7 37.5	201 46.1
	325 74.6	111 25.4	436 100.0

n. a.: 104

A similar correlation can be demonstrated between the assessment of enterprise behaviour and size. A greater than average number of firms usually judge the firm environment to be negative.

Paradoxical as it may seem, those who saw the closest correlation between success and profit had an above average share among those who thought that incorrect, non-market adjusted behaviour would bring success. In contrast to this, those who identified success with growth had an above average share among managers who described successful firm behaviour in market terms.

No significant correlation was found between self-reportedly successful firm behaviour on the one hand and profit, or state or foreign ownership, on the other.

Nearly half the respondents thought that the gravest problems of the economy were related to the market: i. e. drop in demand, and shortages in capital, materials or specialists. Other respondents blamed economic management, taxation, and banks (which may be collectively termed "non-market institutions" from the point of view of enterprises). There was a clear correlation between successful behaviour and economic problems: those who described firm success in positive terms tended

Table 5

What enterprise behaviour can hope for success in relation to the size of the firm?

size (nr. of employees)	what behaviour will be successful?		
	market-oriented	non-market oriented	
–20	203	84	287
	70.7	29.3	65.5
	62.2	75.3	
21–	123	28	151
	81.7	18.3	34.5
	37.8	24.7	
	326	112	438
	74.5	25.5	100.0

n. a.: 102

to name non-market institutions as the sources of economic problems, whereas those who regarded incorrect behaviour as the way to success blamed the market institutions represented an above average proportion.

Although similar in direction, there is a far weaker correlation between successful firm behaviour and the assessment of a firm's gravest problems.

Localizing the sources of problems in the Hungarian economy with respect to market or non-market institutions it was found that there was no significant correlation with profit, firm size or type of owner.

In contrast, enterprise success and the definition of macro-economic problems seemed to be correlated; an above average proportion of successful firms blamed non-market institutions for the problems of the economy as a whole.

Table 6

The sources of problems of the economy and successful firm behaviour

what behaviour will be successful?	the sources of problems in the economy		
	market	non-market institutions	
market-oriented	138	173	311
	44.4	55.6	74.3
	69.1	79.2	
non-market oriented	62	45	107
	57.6	42.4	25.7
	30.9	20.8	
	200	218	419
	47.8	52.2	100.0

n. a.: 121

Table 7

Main sources of the problems of the economy and the success of a firm

sources of problems of the economy	do you regard your firm as successful? non-successful	successful	
market institutions	133 60.1 51.3	88 39.9 42.1	221 47.2
non-market institutions	126 50.9 48.7	121 49.1 57.9	248 52.8
	259 55.3	210 44.7	469 100.0

n. a.: 71

There is a correlation of a similar tendency and strength between the perception of firm problems and firm success. The blame placed on market or non-market institutions for the problems of the company does not seem to correlate with firm size, profit and ownership type (Hungarian or foreign). As against that, state ownership of a firm has an intriguing influence on the localization of perceived enterprise problems. Companies owned fully by the state far more frequently accused non-market institutions as the causes for their problems than companies of other ownership type. At the other extreme are firms partly owned by the state, since they put above-average blame on market institutions for the problems of their firms.

What does the perception of enterprise success correlate with?

Below, a regression equation is used to answer the question concerning what particularities of firms and managers possibly correlate with the assessment of success. Logistic regression models are applied here to find out what managers use to gauge success, how they perceive successful behaviour, and to what do they attribute, respectively, the problems of their firms and economy as a whole. Some fifty figures and information items have been taken into account as possible explanatory variables. Some of these refer to the way firms function, and to their financial and market positions. It also takes into account changes and, to a certain degree, the character of the owners and managers. (The examined variables are described in an appendix.)

Is the firm successful?

$$A03 = 0.216 * B220 - 0.295 * SIKMAG01 - 0.004 * B24E0 - 0.105 * A09I + 0.082 * A09C + 0.008 * A15 - 0.071 * A08G - 0.121 * A09O + 0.058 * A08H - 0.089 * A08B + 0.094 * A08E - 0.13 * A09M + 3.01$$

$$Rsquare = 0.39, \quad F = 14.18(sign. \quad 0.0000)$$

The backward method was used with 0.1 Pout criterion

$$N = 291$$

Interpreting success at interval level, the equation, which involves twelve variables, accounts for almost two-fifths of the extent of success. The correlation of variables, one by one, indicates relatively weak effects (except, perhaps, for the perception of successful behaviour; this reveals that those who deem non-market behaviour as successful mostly belong to the group of unsuccessful company leaders. By contrast, the size of firm exports has a significant positive influence on the perception of success. On the other hand, producing for stocks, delay in social insurance bills or in settling accounts with other firms, as well as changes in the leadership in the past five years, logically have negative influence upon the perception of success. There is also a negative correlation between the assessment of success and the costs of marketing research. This suggests that the latter is a market constraint rather than a necessity for an offensive product strategy. Exports to the west also display a weak negative correlation with the assessment of success. Better utilization of capacity, increase in turnover, and changes in the strategy of enterprise organization have a weak positive influence upon the perception of success.

Logistic regression models may contribute to an examination of the measures which firms use to gauge success, what behaviour they perceive as successful, and what they perceive as economic and enterprise problems. This may help to clarify the specificities which motivate the thinking of firms and management in terms of market and finances. Each of the four logistic regression models were used for the same variables.

The first model reveals that those who gauge success by growth or expansion tend to plan for the long run. Firms that have increased their turnover lately also tend to perceive success in terms of expansion. Those who ascribe economic problems primarily to market causes also name expansion as the main factor behind success.

	Model 1 *What is success gauged by ?* (expansion=1 profit, liquidity=0)			Model 2 *Successful behaviour* (non-market oriented=1, market-oriented=0)		
Variable	B	Wald	Df	B	Wald	Df
A06		14.22	5		11.80	5
A06(1)	−0.97	3.53	1	0.79	4.28	1
A06(2)	−0.28	0.92	1	0.28	1.07	1
A06(3)	−0.19	0.55	1	−0.15	0.32	1
A06(4)	0.07	0.06	1	−0.69	3.45	1
A06(5)	0.94	10.32	1	−0.73	3.06	1
A09C	0.30	9.13	1			
A09P				−0.69	3.56	1
A10				0.28	6.13	1
GAZDPR01	0.89	10.77	1	0.79	7.52	1
CONSTANT	−2.39			−1.78		
Chi sq		35.38			31.49	
Df.:		7			8	

Rate of correctly ranged cases (percent)

profit, liquidity	93.10	market	99.21
expansion	18.28	non-market	5.41
together	71.69	together	77.91

N=329

The first model provides a relatively reliable prognosis of enterprise success and correctly ranges over nine-tenths of those who conceptualize success in financial terms and one-sixth of those who regard expansion as the criterion of success.

Managers who claim that non-market oriented behaviour is more conducive to success represent a higher share of those who have had bad experiences with some of their business partners. Those who are indebted themselves tend to see the token of successful firm behaviour in correct market relations. The range of planning also correlates with the qualification of successful behaviour: the further ahead a firm looks in its planning, the more it tends to perceive business success in terms of correct market behaviour. Those, however, who mainly perceive the macroeconomic problems as market-related problems are more inclined to consider incorrect, aggressive behaviour as successful.

Managers who attribute economic problems to market sources are overrepresented among those who interpret business success in terms of expansion, and also among those who associate successful firm behaviour with features of incorrect behaviour. Those who fail to pay their partners in time mainly stress the market-related problems as being among the macroeconomic problems.

	Model 3			Model 4		
	Sources of economic problems (market=1, non-market institutions=0)			*Sources of enterprise problems* (market=1, non-market institutions=0)		
Variable	B	Wald	Df.	B	Wald	Df.
A09J				0.33	7.36	1
A09O	0.35	6.91	1			
SIKMAG01	0.79	0.29	1			
GAZDPR01*				1.00	8.21	1
VALLPR01**	0.94	7.05	1			
SIKMER01	0.84	10.16	1	−0.72	4.34	1
CONSTANT	−1.75			0.88	7.40	1
Chi sq:		31.95			20.87	
Df.:		4			3	

Rate of correctly ranged cases (percent)

	Model 3	Model 4
market	66.16	100.00
non-market	63.35	0.00
together	64.81	85.54

*dependent variable in the third model
**dependent variable in the fourth model
N=326

In the analysis of the general problems of the economy, the model took into account some two-thirds of the cases—with respect to both the market-related and non-market related institutions—and gave a better prognosis than the model built for the characterization of enterprise problems. The naming of the respective macroeconomic and enterprise problems is consistent in that the actors who pinpointed the main concerns of the economy in non-market institutions also traced the main problems of their firms to such sources. The effect of the measurement of success, however, attests to an intriguing inconsistency. When speaking about the overall problems of the economy, those who associated success with expansion stressed market institutions while those who thought about success in financial terms stressed non-market institutions as the sources.

The interpretation of success also appears to influence the perception of the problems faced by firms. Those who had experienced a reduction in employment in recent years tended to attribute their firms' problems more to market causes.

In this case, however, those who conceptualize success in financial terms have a greater share in ascribing their firms' main problem to market institutions.

Appendix

Description of examined variables

A03	success of the firm (1–5)
A06 (1)	planning perspective—no planning ahead
A06 (2)	planning perspective—planning ahead for less than a year
A06 (3)	planning perspective—planning for a year
A06 (4)	planning perspective—for 2–4 years
A06 (5)	planning perspective—for 5–10 years
A06 (6)	planning perspective—for 11– years
A08A	past 5 years—major change in profile (1–5)
A08B	past 5 years—cutback in employment (1–5)
A08C	past 5 years—merger (1–5)
A08D	past 5 years—de-merger (1–5)
A08E	past 5 years—change of inner structure (1–5)
A08F	past 5 years—expansion at home (1–5)
A08G	past 5 years—new firm management (1–5)
A08H	past 5 years—major strategy change (1–5)
A08I	past 5 years—privatization (1–5)
A08J	past 5 years—conversion into corporation (1–5)
A09A	price rise (1–5)
A09B	change of products (1–5)
A09C	increase in turnover (1–5)
A09D	investment (1–5)
A09E	market change (1–5)
A09F	decreased input (1–5)
A09G	decrease in stocks (1–5)
A09H	organizational transformation (1–5)
A09I	production for stocks (1–5)
A09J	reduction in employment (1–5)
A09K	hiring out of firm assets (1–5)
A09L	selling of firm assets (1–5)
A09M	delay in social insurance payment (1–5)
A09N	delay in tax payment (1–5)
A09O	delay in payment to other firms (1–5)
A09P	delay in bank credit payments (1–5)

A10	partners fail to pay (1–5)
A15	utilization of capacity (percent)
MTUL01	firm is privately owned (0–1)
KULF	firm has foreign owner (0–1)
NYER	firm makes profit (0–1)
SIKMER01	measures success in expansion (0–1)
SIKMAG01	incorrect behaviour may be successful (0–1)
SIK01	successful/unsuccessful (0–1)
LETSZ01	employs above 21 people (0–1)
GAZDPR01	macroproblems are market-related (0–1)
VALLPR01	firm problems are market-related (0–1)
FFI	respondent is male (0–1)
FFOKU	respondent has tertiary education (0–1)
B260	import content percent
B250	export subsidy (millions of HUF)
B24E0	proportion of EU countries in turnover (percent)
B220	frequency of exporting (0–3)
B21B0	proportion of marketing research (percent)
B10B50	proportion of services in turnover (percent)
B1110	proportion of wholesale customers in turnover (percent)
B120	cost of labour (percent)
B21A0	proportion of promotion (percent)

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SUBSIDIES AND REDISTRIBUTION IN THE HUNGARIAN HOUSING SECTOR

ZS. DÁNIEL

Before the change of political system took place, the Hungarian public was dissatisfied with the housing policy. Retrospectively, this verdict seems to have changed over the last few years. The public has become more indulgent towards the earlier housing troubles and concerns, while experiencing new ones intensively and painfully. The author challenges such negative feelings. This study examines the effects of state subsidies in the Hungarian housing sector: what effect do subsidies have on housing construction and housing consumption; what part do housing subsidies play in the redistribution of material welfare? An attempt has been made to distinguish the inherited problems from the new mistakes.

1. Introduction[1]

This study examines the effects of state subsidies in the Hungarian housing sector. It sets out to clarify two related groups of questions. First, what effect do subsidies have on housing construction and housing consumption, and on supply and demand for homes? Secondly, what part do housing subsidies play in the redistribution of material welfare?

The redistributive effect of housing subsidies has been examined in earlier studies by *Dániel* (1985), *Hegedűs, Struyk and Tosics* (1991) and *Pudney* (1995); these concentrated solely on the state rental sector. The cost-based imputed rent calculations estimated by Dániel (1985)—using the 1976 household budget survey (HBS) statistics—took account of the quality differences of housing, but they did not attempt to simulate market-equilibrium prices. The other authors mentioned simulated market rents, again based on HBS data, but they used different approaches. Hegedűs, Struyk and Tosics based their calculations on actual market rents on the extremely limited market for private rental housing, as recorded by brokers. The basis for Pudney's estimate of differentiated imputed rent involved privatization-based prices, starting from the estimated market value of a particular dwelling.

[1] This study was carried out under the auspices of the Hungarian National Scientific Research Fund (OTKA) research programmes No. 018132 and No. 029028, with support from the Institute for Economic Analysis and Information of the Central Statistical Office. I am especially grateful to György *Bánkövi*, Attila *Fölsz* and István *Palócz* for their tireless and preserving help in making the computations, to Pál *Cseh* and Sára *Szecskő* for their assistance in assembling the data, and to Julianna *Parti* for her editorial help. I would like to express my gratitude to Brian *McLean* for the excellent translation.

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This article goes further in two essential respects. On the one hand, it extends the analysis to cover housing-market subsidies to owner-occupied homes. In other words, it examines the effects of the Hungarian system of housing subsidies over a wider spectrum than the earlier studies. On the other hand, the analysis is not confined to a single moment in time. The more recent data now available allows it to examine a longer period.

Attention is centred on 1989, which was the last year before Hungary's systemic change. These figures, offering a final "snapshot" of the housing sector as it operated under the socialist system, serve as the main basis for the analysis. They can be compared with the data of the 1970s (i.e. the start of the reform process), and with data for the post-socialist transition up to 1995. This makes it possible to draw some conclusions about typical changes over time.

The structure of the article is as follows: *Section 2* looks at the data sources for the analysis and the method of measuring the subsidies; *Section 3* examines the assessment criteria; *Section 4* analyses the main characteristics of the subsidy system and the changes in it over time; *Section 5* is concerned with the scale and nature of the subsidies and their effect on shortage; *Sections 6 and 7* examine the biases in the subsidy system, the composition of the winning and losing groups, and the effect of subsidies on social inequity; finally, *Section 7* sums up the conclusions.

2. Measuring the size and structure of the subsidies

There is broad, factual data available for the housing stock in the years examined and also for the composition and expenditures of households living in owner-occupied or rental dwellings.[2] However, there are no official data for the more immediate subject of this research—i.e. part of the aggregate total of housing subsidies and the distribution of the subsidies among households. These have had to be estimated indirectly.

[2]The computations are based on the Household budget survey (*KSH* 1993 and 1996a), complemented by the Annual report on the Central budget and by calculations of the Ministry of Finance, (Incidence 1989) and the *World Bank* (1991).

HBS covers 12,000 randomly selected households. The household is the unit of observation. The survey gives a detailed description of household expenditure financed from disposable income (i.e. net of pension-fund contributions and income tax, and not including benefits in kind). The survey also covers housing conditions (e.g. ownership, location, size, and quality parameters of the dwelling), and the holiday homes and stock of durables in the household. The representative sample provides information on the size and composition of the household and on its principal earner (e.g. age, occupation, education, etc.).

The macro total of subsidies

An initial clarification of the concepts involved is provided in *Figure 1*.

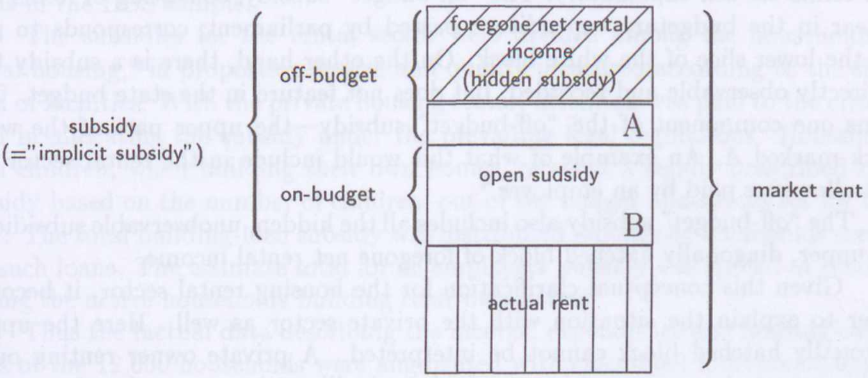

Fig. 1 Clarification of concepts

It is useful to take first the case of rental housing in state ownership. The concepts introduced in this context make it easier to clarify the concepts applied to privately-owned housing.

As a first approach, the difference between the market rent of rental housing and the total rent actually paid, can be considered as a subsidy.[3] This is shown by the two upper blocks of the column in the figure—namely, the parts hatched diagonally and left white, respectively.

The subsidy is divided into several parts. It breaks down primarily according to how far it can be measured directly. The middle, white block of the diagram contains the measurable, recorded, "open" subsidy. (This includes, for instance, the state's contribution to the maintenance costs of state rental housing.)

However, there is a concealed, unrecorded part of the subsidy as well, represented by the diagonally hatched block. In order to understand this it helps to consider a hypothetical case. If the housing sector were in private ownership and operated on market principles, it would yield under normal circumstances a clear net income from the rent, which the state as the owner of the housing foregoes. That foregone net rental income—i.e. the margin between the market rent and

[3] *Aaron*, in his book on the measurement and assessment issues associated with subsidies (1972), calls this category "implicit public housing subsidy". Its size is determined by the difference between the rent of a non-subsidised dwelling and the actual rent paid. The interpretation here is in full conceptual accord with Aaron's definition.

the costs financed by the explicit subsidy plus the actual rent paid—is a sizeable component of the total subsidy.

There is another important distinction found in the literature on the subject and in the recording of data—namely, between "on-budget" and "off-budget" subsidies. The diagram marks this with a horizontal line, where the two braces meet. The terms are self-explanatory. The "on-budget" subsidy, consisting of items that appear in the budgetary expenditure passed by parliament, corresponds to part B—the lower slice of the white block. On the other hand, there is a subsidy that is directly observable and recorded, but does not feature in the state budget. This forms one component of the "off-budget" subsidy—the upper part of the white block marked A. An example of what this would include in the rental sector is a rent allowance paid by an employer.[4]

The "off-budget" subsidy also includes all the hidden, unobservable subsidies—the upper, diagonally hatched block of foregone net rental income.

Given this conceptual clarification for the housing rental sector, it becomes easier to explain the situation with the private sector as well. Here the upper, diagonally hatched block cannot be interpreted. A private owner renting out a dwelling wants to receive net income for it and will not be prepared to forego this. With owner-occupied housing, the owners, figuratively speaking, pay themselves an imputed rent. So there can only be a question of open subsidy in this case. Part of this is on-budget (for instance, the interest-rate subsidy given by the state budget on loans for building private housing) and part is off-budget (such as an employer's subsidy for housing construction).

Of the components mentioned, there were observed data available for actual rents and for open subsidy; in other words for the lower, vertically hatched and white middle blocks of the column in *Figure 1*. A numerical estimate for the foregone net rental income, and for the employer's subsidy for private house building—i.e. the diagonally hatched upper block—was taken from the World Bank (1991) study.[5]

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[4]This example appears for the purpose of conceptual clarification. No such item existed under the Hungarian conditions described in the study, but in other countries, such as China, it played an important part.

[5]The World Bank (1991) study started out from data on the so-called "grey" housing prices, since there were no direct observations of market prices available. The following type of transaction was widespread under Hungarian conditions at the time. A tenant of state-owned rental housing felt like an owner, as he or she could not be evicted, and even in the case of death, the tenancy (*de facto* ownership) could be inherited. So the right of tenancy could be sold. This was not entirely legal ("white"), but if the bureaucratic rules were formally observed, it was not really illegal ("black") either. The tenancy was sold at a "grey" price that expressed the discounted present value of the future subsidy process. Therefore the market price and the foregone rental income could be deduced from the "grey" price.

The World Bank used this piece of data as had in several other, earlier research programmes.

The distribution of subsidies among households

Taking the macro estimate, an attempt was then made to estimate how the total subsidy is dispersed among households. A very detailed simulation model was applied to "distribute" the total subsidy among the 12,000 representative households in the HBS sample.

The subsidies for the rental sector were divided among the households in rental housing,[6] in proportion to size and quality measured according to the standard of facilities. With the private housing sector, attention was paid to the criteria used in allocating the subsidy under the prevailing legal regulations. Households with children, when building their own homes, received a legally prescribed cash subsidy based on the number of children, out of the budget allocations set for that year. The total building-loan subsidy was distributed among the households servicing such loans. The estimate total for an employers' subsidy was spread at random among the active households building their own homes.

Thus the factual data describing the income, expenditure and housing conditions of the 12,000 households were augmented with calculated individual-subsidy data, typical for each household and compatible with the factual data.

This finally yielded a household sample embodying the real parameters for each household and those calculated by simulation. The latter are put forward as an acceptable representation of the subsidy distribution among households, based on the indirect information available.

3. Assessment of the subsidies

One purpose of this research has been to answer positive questions. What is the trend in the size and distribution of housing subsidies? What characteristic changes have occurred in the period 1976–1989–1995?

Another purpose is to assess the effect of the subsidies and the consequences of changes in them. These have been examined from two points of view:

1. What is the effect of the subsidies on housing construction and housing consumption at each moment in time? How do they influence housing supply and demand? Do they promote efficiency in the sector? What effect do they exert on the balance of the market? Do they help to overcome the housing shortage? What effect has changing the subsidies had on these economic relations?

2. What effect do housing subsidies and their changes over time have on income distribution? Who are the winners and losers? How much has the subsidy

[6] *Table A1* compares the numerical results using various methods for estimating the subsidy on rental housing.

system helped to realize its declared aims of helping the needy and large families most of all? Has it increased or reduced inequality of income?

The categories applied here largely correspond with the two criteria found in literature on the subject—equity and efficiency—although they are expressed in a broader, less restrictive way. (On these see Aaron 1972, *Bradbury and Downs* 1981, *Rosen* 1983, and *Sen* 1992.)

4. The trend in subsidies—a synopsis

On the one hand, the subsidy system in the decades right up to 1989 bore marks of the classic, pre-reform socialist system;[7] on the other hand, it included elements of the market reforms of the 1970s, designed to encourage private owner-occupation. Sizeable sums from the state budget were spent on building and maintaining public rental housing. During the large-scale building programmes of the 1970s and 1980s, loans for owner-occupiers were extended at negative rates of real interest. The cost effects of these became acute by end of the 1980s, in an economic environment marked by two-digit inflation. The policies of earlier years collapsed in 1988–89, by which time the consolidated sum of central and local-government subsidies had reached 6 percent of GDP, as against 3 percent in the early 1980s.

Adding up the on-budget and off-budget subsidies, it can be seen that no less than HUF 8.6 out of every HUF 100 of GDP in 1989 went on subsidising housing.[8]

Table 1 shows the trend in the total for on and off-budget subsidies from 1989 to 1995. Net of utility expenses, Hungarians in 1989 spent on average 12 percent of their monetary income to housing. On the other hand, they received back, as housing subsidy, one-and-a-half times as much—a sum equivalent to 18 percent of their income.

[7] The operation of the housing sector was determined by the centrally distorted wage and price system and by bureaucratic restrictions. For example, wages did not account for expenditures related to housing, health, education and other essential basic needs and services, which were provided for a nominal price. To raise the revenues necessary to cover those services, the state implicitly taxed gross income and only disbursed "net" wages to its employees. Private housing became unaffordable because access to subsidies was very limited, while the low national wage level affected everybody. For more detail, see *Buckley, Dániel and Thalwitz* in *Buckley* (1996).

[8] There are both budgetary and extra-budgetary subsidies on housing in developed market economies as well, but the scale of these is substantially smaller. See *Stahl and Struyk* (1985), and *Hegedűs, Mark and Tosics* (1993). The estimate made in 1990 by the *World Bank* (1992) expressed the on and off- budget housing subsidies of 52 countries, at various levels of development, as a proportion of budget expenditure in the previous year. The average proportion was 5.3 percent, with a spread between 0 and 15 percent. The index for Hungary was 14.5 percent—this was high for a country at a medium level of development. It is worth noting that the ratio of budget spending to GDP in Hungary was much higher than in other countries at a similar level of development and even higher than in developed countries. Thus the relative weight of redistribution for housing purposes was even higher.

Table 1
On and off-budget subsidies

Attribute	1989	1991	1993	1995
1) On and off-budget subsidy per HUF 100 of net income (HUF)	18.0	9.6	7.2	6.1
2) Proportion of households receiving housing subsidy (percent)	70.7	55.3	49.1	43.0
3) Subsidy received per HUF 100 of recipients' net income	28.9	15.2	14.3	13.7
4) Distribution by source (percent):				
On-budget	69.1	62.9	66.3	90.5
Off-budget	30.9	37.1	33.7	9.5
5) Distribution by designation (percent):				
Inherited obligations*	85.6	65.4	60.1	57.0
Subsidies for new purposes:				
Building subsidies	14.0	24.9	31.6	32.7
Social subsidies	0.4	6.7	8.3	10.3

Note: *"Inherited obligations" denote the payments made in the year under earlier subsidy schemes, such as on and off-budget subsidies for rental housing, and interest-payment subsidies on earlier loans.

About two-thirds of the subsidy (HUF 12.4 per head) reached households direct from the budget, and one-third (HUF 5.6) by other, hidden, non-transparent channels. Citizens did not know who was receiving subsidies, in what form, or to what extent. Even the state only realised after the event the full extent of the obligations it had taken on, when the effects of the accumulated expenditure and resulting strains on the budget emerged.

Housing subsidies were extremely widespread under the socialist system: about 70 percent of the population received them on some score, and many on more than one score. For every HUF 100 of monetary income, subsidy recipients received a further HUF 28.90 in housing subsidy on various grounds. The remaining 30 percent, the non-recipients, received no housing subsidy at all, even though their average income was 8 percent lower and their average housing conditions 6 percent worse than the recipients' The redistribution system meant ultimately that one third of the population supported people better off than themselves in every respect.

The reduction and withdrawal of budget subsidies began in 1990. The most important change was that rental housing passed into the ownership of local government. This decision meant that direct budget subsidies to the rental housing sector ceased altogether.[9] The housing-subsidy total (and thereby the budget expenditure) was also reduced by altering the interest terms on pre-1989 housing-

[9] Thereafter local government received a budget subsidy on a substantially lower, steadily decreasing level. It was empowered to distribute this among the remaining rental housing sector and those in need.

construction loans. After 1990, interest payments on earlier loans were raised, so as to follow inflation to some extent.[10] The 1995 budget still included a residual liability of about HUF 42 billion, amounting to about a third of the annual housing subsidies. Taxpayers are likely to have to continue to pay for many years, on behalf of about 100,000 households; this is due to difference between a market rate of interest and the low interest rate featuring in the housing-loan contracts of those households.

Despite two-digit inflation, the total volume of housing-subsidy expenditure fell even in nominal terms in the 1990s. As a proportion of monetary income of the recipients, on and off-budget housing subsidies together fell from the earlier 28.9 percent, to 14.3 percent in 1993 and 13.7 percent in 1995. There was also a steady contraction in the sphere of recipients. However, housing subsidies were still going to about *half* the population in 1993, and 43 percent in 1995.

5. Effect on housing construction, consumption and shortage

In the subjective view of the Hungarian public and in official evaluations, the housing shortage has been the central problem of housing policy for decades. In housing policy debates that began at the end of the 1970s, some authors blamed the reproduction of the housing shortage mainly on the unrealistically low rents and the bureaucratic restrictions on market forces. (Dániel 1977, 1983, 1989; *Hegedűs and Tosics* 1993; *Kornai* 1980) Despite its rhetoric of reform, the government only raised rents in the 1970s and 1980s to an insignificant extent. Policy-makers tried to combat the shortage on the supply side. This is shown in *Table 2*. They set out to increase the supply in two main ways. (i) The rate of construction of public housing began to speed up in the 1970s. (ii) The sphere of subsidies was extended widely to those building their own homes. A big part in boosting private house-building was played by the expanding scope for market coordination; this was accepted as a fact albeit without being officially acknowledged. Tens of thousands of households in the 1970s and 1980s were helped in finding homes by the expansion of the second economy, the sizeable increase in the sources of household income, and the spread of self-organised construction based on the reciprocated labour of family and friends. (*Vajda and Farkas* 1990; Hegedűs and Tosics 1993; *Manchin and Szelényi* 1980)

[10] Borrowers were offered a choice. They could pay a higher rate of interest than the one in the original contract (though still short of being positive in real terms), or have 40 percent of their loans waived and repay the rest straight away. The stock of housing loans under the earlier terms stood at HUF 244.1 bn in 1989 (*KSH* 1990, p. 332). By July 1995 the stock had fallen to HUF 42.8 bn. However, many of those who had accepted the higher rate were not paying the interest. The National Savings Bank (OTP) registered payment arrears totalling about HUF 10bn in 1995. In 1997, there were 10,000 households unable to repay their earlier housing loans, so that current law would allow eviction proceedings to be taken against them.

Table 2
Housing completions according to source of finance

		State-funded		Private house-building	
Period	Total*	Rental	Sold by local government	With state credit	Without state credit
1974–75	438,138	75,379	55,467	184,692	54,007
1976–80	452,715	90,446	54,800	190,879	34,238
1981–85	369,684	48,585	23,045	192,775	7,270
1986–90	272,489	19,650	0	174,709	3,883
1989	51,487	2,776	0	32,422	540
1990	43,771	1,826	0	31,290	717
1991	33,164	1,200+115**	273	31,585	
1992	25,807	279+161	297	24,817	
1993	20,925	181+16	79	20,382	
1994	20,947				
1995	24,718				

Notes: *The total includes other state sources, such as housing construction for the armed forces.
**Central and local government combined+housing built for rent by private persons.
Source: *Lakásstatisztikai évkönyv* (Housing statistics yearbook), various years, Budapest: KSH.

For about a decade and a half, Hungary was in the "international vanguard" for the number of housing completions per capita.

Table 3 summarizes the changes in housing consumption, based on the household budget statistics.[11] Average housing conditions improved by almost 50 percent between 1976 and 1989.

However, it would distort the picture to include this impressive quantitative growth alone. The subsidies gave preference to new building and to a quantitative rise in the housing stock, while maintenance of the existing housing stock was neglected.[12] This renovation backlog greatly reduced the asset value of the rental housing. The overall decline in value was put at HUF 440 billion in 1989, which represented some 42 percent of the asset value. (*Farkas* 1993)

[11] Housing consumption is measured with the constructed index of per capita "quality rooms" or "quality area". This so-called *hedonic index* sets out to express in a single figure features corresponding to several housing specifications observed in the actual household budget statistics—such as size of the dwelling, degree of convenience or quality of the heating system. The basic idea is this: more comfortable dwellings have been "upgraded" in accordance with grey-market evaluation, as compared with dwellings of the same size but of poorer quality. This additional quality, like comfort or modern heating, has been expressed not in terms of money but in additional rooms (or area). For further information, see Dániel (1985).

[12] For a more detailed account of the quantity drive, postponements and neglect typical of the socialist system, see Kornai (1972, 1980 and 1992).

Table 3

Changes in housing conditions between 1976 and 1995 (Quality rooms per head)

Attribute	1976	1989	1995
In rented housing	1.53	1.99	1.75
In owner-occupied housing	1.21	1.87	2.12
Budapest	1.71	2.22	2.39
Provincial town	1.44	1.97	2.14
Village	1.02	1.68	1.90
No children	1.53	2.41	2.80
1 child	1.18*	1.78	1.88
2 children	–	1.55	1.62
3 or more children	0.67	1.17	1.14
Active age	1.23	1.75	1.89
Inactive age	1.45	2.44	2.57
Total	1.27	1.89	2.09

Note: *The figures for one and two-child households are combined in the statistics for 1976.

Moreover, with such low rents, even the increased supply of housing could not possibly satisfy the demand for bigger and better flats. The high volume and wide distribution of subsidies encouraged many households to include in "excess consumption". The earlier "quantitative" shortage of rental housing turned increasingly into a "structural", "qualitative" shortage. (*Dániel and Semjén* 1987) A paradoxical situation arose in which the housing shortage remained, while average housing consumption exceeded the level which matched the country's economic development.[13]

What changes took place after the systemic change, between 1989 and 1995? The construction of rental housing out of state or local-government funds almost ceased completely during the transformational recession, when GDP declined and then stagnated. (*Kornai* 1995) The pace of private housing construction also showed down considerably, although the official figures probably do not reflect adequately a conspicuous surge in construction by the wealthier strata of society.[14]

Since it was mainly larger, better-quality dwellings that were built after 1990, the total supply of housing ultimately grew, despite the decline in the rate of

[13] In a comparison of 22 European countries—in KSH (1994b)—Hungary came 19th for per capita GDP. However, it scored higher for aggregate indices of housing conditions: 16th for housing stock per 1000 population and 14th for number of persons per room.

This conclusion is backed by a comparison for Budapest based on the World Bank's "extensive housing indicators" data base and the "East-Central European housing indicator" data base compiled by Városkutatás Kft. (Urban Research Ltd).

[14] The household statistics sample underrepresents the households living under the worst and the best financial conditions, especially in the years after the systemic change. Due to the shortcomings at the extremes of the sample, the real differences may be greater than those we have calculated.

construction.[15] Average housing consumption increased by about 10 percent (*Table 3*). Meanwhile, there began an adjustment of the structure of housing consumption to the composition of actual solvent demand. This was linked not only with the supply-side phenomenon just mentioned—the boom in house-building by the wealthier strata—but to changes in the demand.

Many people have had the chance to move into larger or better accommodation more suited to their needs and financial circumstances. Others have gradually had to face the fact that at market prices, their income no longer covers the running costs of their former housing consumption,[16] let alone the imminent renovation expenses of privatised homes. For most households, the main problem is no longer a shortage of housing, but affordability. The end of the housing shortage can be ascribed to a sharp contraction in demand.[17] The earlier supply constraints have given way to demand constraints.[18]

6. The biases in the subsidy system: winners and losers

Table 4 presents the bias and scale of bias in the system of subsidies according to social groups, composed on the basis of various measures. The advantages and disadvantages have been evaluated against the average subsidy received by households as a whole. The first column shows the relative size of the gain or loss as a percentage of the average subsidy. The second column gives the subsidy per HUF 100 of income, and the third the subsidy to each group per quality square metre.

The average of the direct and indirect housing subsidies in 1989 was HUF 18 per HUF 100 of income and HUF 218 per quality square metre.

Conspicuous among those receiving a *greater than average* subsidy were the occupants of rental housing. Their gain was almost twice the national average. Households in rental accommodation (about a fifth of the total) spent an average

[15] The mean size of newly built dwellings was 85 sq.m. in 1989 and 99 sq.m. in 1995. Further improvements in quality derived from the rehabilitation and comfort-improvement of existing dwellings.

[16] The state has withdrawn subsidies on utilities and other housing related expenditures, (see *Table A2*).

[17] For further detail, see KSH (1994a), *Farkas, Vajda and Vita* (1997) and *Hegedűs, Kovács and Tosics* (1994).

[18] János Kornai, discussing the elimination of the housing shortage, points out that "a distinction must be drawn between (housing shortage) ... and the actual housing situation, the 'consumption' of housing ... The housing sector contains a finite stock of housing at a certain time which will be allocated one way or another. A high proportion of the dwellings in poorer, more backward countries are cramped and poor in quality. Many people live in housing squalor. This depressing phenomenon may apply equally if there is excess demand on the market, in other words, a housing shortage, or if there is excess supply on the market, and households do not have enough money to create for themselves the housing conditions they desire." Kornai (1997, p. 19)

Table 4

The composition of the "winner" and "loser" groups in 1989

Attribute	Total subsidy	Subsidy	
		relative to income	relative to quality area
Average for households	HUF 13,808 per capita	HUF 18/ HUF 100	HUF 218/m^2
Recipients of a *higher* than average subsidy (percentages of average value)			
Tenants of rental housing	187.2	32.6	421
Graduates	182.5	23.0	342
Budapest residents	155.5	24.0	312
Three or more children	121.5	29.2	432
Recipients of a *lower* than average subsidy (percentages of average value)			
Less than eight grades of schooling	44.9	9.6	98
Village residents	69.6	13.3	160
Owner-occupiers	80.5	14.3	170
Inactive households	88.4	17.4	144

of HUF 5.70 out of every HUF 100 of income on rent, and another HUF 2.90 on purchasing, building, or servicing loans on another piece of real estate. Although most of the subsidy they received was rent subsidy (HUF 29.30 per HUF 100 of income), many tenants in rental housing also received house-building subsidies (an average of HUF 3.30 per HUF 100 of income). Because tenants in rental housing could save more, the rate of holiday-home ownership among them was 14 per hundred households, as opposed to 6 per hundred households among owner-occupiers. Comparing Budapest tenants and owner-occupiers in the top quarter with respect to housing conditions, the money income of the tenants was 25 percent lower, but the incidence of holiday-home ownership was 26 percent higher than among owner-occupiers. Comparing the top fifth with respect to income among tenants and owner-occupiers produces a similar picture: 24 holiday homes per 100 households in rental housing and 12 per 100 households in owner-occupied housing.

According to the table, the "winners" included those with a higher education. Their incomes were 40 percent higher than average and the housing subsidies they received (on various grounds) were 80 percent higher.[19]

As the ideological constraints on acquiring property loosened in the 1970s, the attention of the political and economic elite in higher positions turned towards private house-building. Many households with the right connections with the ruling

[19]The household statistics show a sizeable overlap between the households belonging to the political, the economic and the intellectual elites and those with the highest level of education.

authorities managed to obtain building land from the state on 100-year rent-free leases; these leases became freehold at the end of the 1980s. Many of the elite began selling their rental housing in the early 1980s, but 30 percent of them still lived in very heavily subsidised rental housing even in 1989. The highly qualified were spending twice the national average sum on house-building, housing purchase and repayment of housing loans.

The only group receiving higher than average housing subsidies *that was legitimately entitled to do so* according to social or need criteria were low-income households with several children. They had actually been "losers" in earlier decades. (*Konrád and Szelényi* 1969; Dániel 1985, 1995; *Szelényi* 1983) Their housing conditions improved noticeably and their housing costs fell as the need principle came to apply more strongly in allocating rental housing (where 19 percent of them lived in 1989), and building subsidies depending on the number of children were introduced. This was a creditable achievement of the 1980s.

Turning to the "relative losers", the groups that received *less than average* housing subsidies were the poorly qualified, those living in villages, and those over retirement. These groups included most of the 30 percent of households receiving no housing subsidy at all (*Table 1*). Many lived in private housing from earlier periods that had never been subsidised.

The last column of the table shows the subsidy per quality square metre of housing. It is remarkable that rental housing received two-and-a-half times as much subsidy per quality square metre as owner-occupied housing. Moreover, the housing of those with the highest educational qualifications received three-and-a-half times as much subsidy per square metre as the housing of those with the lowest qualifications.

Table 5 shows the changes in the composition of the "winning" and "losing" groups and in the scale of subsidies after 1990. The tenants of local government-owned housing still receive a subsidy, but to a lesser extent. It has fallen, as a proportion of their income, from the earlier 32.6 percent to a still not inconsiderable 12 percent. Two-thirds of this derives from subsidies which were spent on rent assistance for public dwellings, and a third from subsidies given for a private second home under construction. The withdrawal or reduction of the current subsidies has had most affect on Budapest households and inactive households. The subsidy to Budapest households, previously 50 percent higher than average, fell in 1995 to 70 percent of the average, so that from being "winners" they became "losers". The subsidy received fell to less than a third: from HUF 24 to HUF 7.1 per HUF 100 of income. Inactive households remained the "losers" they were, but the scale of subsidy in 1995 was down to less than half the average. The main explanation with respect to both groups must be sought in the effect of the privatization of public housing. Meanwhile current housing subsidies have ceased, and paying the high condominium fees and electricity and gas bills often causes serious problems to households.

Table 5

The composition of the "winner" and "loser" groups and the subsidization trend between 1989 and 1995

Attribute	1989	1995
Average for households (HUF per capita)	13,808	11,542
Recipients of a *higher* than average subsidy in 1989 (percentages of average subsidy)		
Tenants of rental housing	187.2	163.8
Graduates	182.5	125.6
Budapest residents	155.5	71.0
Three or more children	121.5	254.0
Recipients of a *lower* than average subsidy in 1989 (percentages of average value)		
Less than eight grades of schooling	44.9	40.2
Village residents	69.6	105.1
Owner-occupiers	80.5	93.9
Inactive households	88.4	43.6

There was a marked improvement after 1990 in the position of two, partly overlapping groups: those with several children and those living in villages. In 1994 and 1995, large village families were the main beneficiaries of very generous house-building subsidies, paid after the number of children.

Table 6 shows multivariate regression estimates that summarise the findings on the distribution of housing subsidies in 1989 and 1995. The results strongly support the analysis just given.

The independent variable is the sum of the per capita on and off-budget subsidies received by households. The explanatory variables that feature are: per capita household income, per capita quality square metre, educational level of the household head, age of the household head (active or inactive), number of children, and the ownership type of the dwelling occupied (i.e. rental or owner-occupied).

There was a good fit for 1989. The type of ownership and the age of the household head were significant for the share of subsidies. Those living in rental housing had an advantage over those in owner-occupied housing, and this was the case for the active over the inactive. There was a strong positive relationship with respect to the amount of subsidy and a higher level of education, and also with the number of children; thus it can be seen that the better educated and families with several children were favoured. There was also a strong positive relationship between the subsidy and the size of dwelling: the bigger and higher-quality the dwelling occupied, the greater was the chance of receiving a state subsidy. A weaker, but still positive relationship was found between subsidy and income. This suggests that the subsidy system is regressive, preferring those with higher incomes.

Table 6

Explanation for the distribution of housing subsidies in 1989 and 1995

Attribute	1989	1995
Dependent variable: per capita housing subsidies for households		
Independent variables:		
Constant	−5,121.5	−8,836.2
	(−14.2)	(−4.6)
Household income per capita	0.028	0.037
	(8.3)	(5.6)
Number of children in household	599.8	5,894.0
	(4.3)	(10.3)
Age of head of household (active vs. inactive)	2,143.1	4,079.6
	(7.4)	(3.1)
Educational level of head of household	986.7	7.3
	(16.7)	(0.1)
Per capita quality living area of household	72.6	42.2
	(27.0)	(3.0)
Type of property (rental vs. owner-occupied)	20,798.0	10,206.3
	(76.3)	(5.4)
Number of observations	11,650	10,565
Adjusted R^2	0.411	0.018

Note: The figures in parentheses represent values of the T-statistics.

In 1995 there was a much weaker fit, but a still significant relationship, between subsidies and rental housing, and between subsidies and families with several children. The subsidy system still favoured those occupying larger dwellings and those with higher incomes. Furthermore, age still proved to be a significant explanatory factor, with the active preferred over the inactive. In 1995 there was no significant relationship between subsidies and level of education.

The regression calculations also confirm that the attributes of the earlier subsidy system have survived the systemic change, so that the characteristic traits have not developed to match the new circumstances. Although the situation for households with several children began to improve from the 1980s, the basic system of subsidies remained and the change was thus a *marginal* one. Large families were given higher priority; however, there was no income ceiling for receiving subsidy, and the principle of need was still applied with a wide degree of dispersion—in fact, almost at random.

7. The tendency towards inequality

Table 7

The trend in the inequality of income and housing between 1989 and 1995

Attribute	1989	1995
Monetary income		
Variation coefficient (percent)	45.90	50.62
Gini Coefficient	0.21	0.24
Robin Hood Index	14.60	16.50
Uppermost/lowermost decile	3.37	3.58
Quality area		
Variation coefficient (percent)	60.10	62.54
Gini Coefficient	0.30	0.32
Robin Hood Index	14.84	22.16
Uppermost/lowermost decile	9.64	9.87

Table 8

The change in the cumulative proportions of incomes and housing subsidies, by income deciles, between 1989 and 1995 (percent)

Income deciles	Net monetary income	Housing subsidy	Net monetary income	Housing subsidy
	1989		1995	
1.	4.9	8.3	4.1	6.8
2.	11.4	15.3	9.9	21.3
3.	18.7	22.2	16.8	31.4
4.	26.7	30.7	24.7	38.7
5.	35.4	38.7	33.5	50.3
6.	44.9	47.4	43.2	59.7
7.	55.3	59.0	53.9	70.6
8.	67.0	69.1	65.8	77.0
9.	80.6	81.1	79.5	87.2
10.	100.0	100.0	100.0	100.0

The main inequality indices are summarised in *Table 7*. *Table 8* presents the cumulative shares of income and housing subsidies according to income deciles.[20] The income-enhancing effect of housing subsidies and the "privatization subsidies" in the public rental sector are shown in *Table 9*.[21]

Table 9

Effect of the current and privatization subsidies on inequality in 1989

Attribute	By available income	By income with current subsidy	By income with annualized privatization "gift"
All households	45.90	55.41	59.12
By income			
Lowest 25 percent	18.45	27.67	62.12
Top 25 percent	35.68	42.71	49.85
Tenants of rental housing	43.01	42.74	50.77
Owner occupiers	46.65	58.32	–
Active age	43.28	50.06	44.90
Inactive age	55.85	74.81	73.98
Budapest residents	48.16	49.27	55.42
Provincial towns	40.92	50.07	56.00
Villagers	47.19	61.23	61.17
Childless	50.15	53.73	67.46
Three or more children	39.08	91.25	39.42
Eight grades of primary school	38.02	57.76	52.83
Higher education	48.34	52.51	46.07

Note: The inequalities have been measured in percent with the coefficient of variation. For the measurement problems of inequality, see Atkinson and Micklewright (1992), Dániel (1997) and *Sen* (1973).

[20] Inequality is measured using several indices.

A higher value for the *variation coefficient* means a higher degree of inequality.

The value of the *Gini Coefficient* lies between 0 and 1. A value of 0 means prefect equality—i.e. every person (household) receives the same income. A value of 1 means that one person (household) receives all the income.

The *Robin Hood Index* (*Atkinson and Micklewright* 1992) starts from an assumption of perfect equality, in which each decile would receive 10 percent of the total income. The index shows the departure from that equal distribution. The question addressed is: what would be the maximum proportion that could be redistributed, if there were a Robin Hood who could take from the rich and give to the poor?

We also employ the *ratio between the uppermost and lowermost deciles* (the 10/1 index).

[21] Households previously living in subsidised public housing bought their homes and received, as a "severance payment" for the lost subsidy, a "privatisation gift" averaging eight years' income (after renovation costs of neglected dwellings had been deducted). However, many people have failed to benefit from this potential gift, partly because they lack the funds to renovate the flat, and partly because the housing market lacks the organisational requirements for mobility; this creates obstacles to moving into a smaller, less expensive home. On this, see Dániel (1997).

The following conclusions can be drawn:

1. Whatever period is examined, the inequality in the distribution of housing conditions (i.e. housing consumption) is greater than the inequality in the distribution of monetary income.[22]

2. The inequality of monetary incomes increased during the transition, i.e. after 1989. (The variation coefficient rose from 45.9 percent in 1989, to 50.6 percent in 1995.) The inequality of housing conditions also increased, but to a much smaller extent. The two types of inequality converged because the shortage was eliminated and there was a decrease in the scale of subsidies; earlier this scale had caused inequality to diverge in a dysfunctional way.

3. The basic explanation for the phenomena described under point 1 is that the inequality of housing subsidies was greater than the inequality of the distribution of monetary income. The latter had a variation coefficient of 46 percent in 1989, while the variation coefficient of the income plus subsidy was 56 percent.

Table 8 shows clearly that the distribution of subsidies was regressive and favoured households with higher incomes. Hegedűs, Struyk and Tosics (1991) and Pudney (1995) reached the same conclusions with regard to the distribution of rent subsidies. In 1989, the bottom two deciles for income received 15 percent of all subsidies. The middle six deciles received another 55 percent, and the top two deciles—the wealthiest fifth of the population—received 30 percent. The distribution remained regressive in 1995, so that the subsidies were still increasing and not reducing inequality, although the proportions had somewhat improved. The households in the bottom two deciles received 21 percent subsidies—slightly more than their share of the population. The households in the top two deciles still received a sizeable 22.6 percent of the total subsidies, although this proportion had become more moderate.

4. Monetary incomes, subsidies and housing conditions all affect the material welfare of households. State redistribution is normally expected to reduce inequality in the distribution of welfare. The effect that the mass privatisation of rental housing—following the change of the socialist system—exerted on social inequality appears in *Table 9*. This reveals how the privatisation of rental housing, at much lower than market prices, exacerbated the social effect of the earlier, dysfunctional subsidy system. It further enhanced the inequality of income distribution by constituting a one-off "national gift" that "compounded" the effect of the running rent subsidy (Dániel 1997).

[22] The KSH corrects the income declared in the household statistical survey by adding to it the undeclared income from the second economy, which has considerable weight. Even so, it is possible that the survey underestimates the income from the hidden economy, which may affect the values of the inequality indices as well.

8. Concluding remarks

To sum up, the housing subsidy system under the socialist regime contributed to the improvement of the overall housing conditions and housing consumption. As it operated at a low level of efficiency, society paid a disproportionate price for the improvement of housing conditions. Furthermore, housing subsidies did not fulfil their purpose in social-policy terms. Ultimately, the system of subsidies increased social inequality and effected a redistribution in favour of those with higher incomes and better living conditions. The established system of state housing subsidies in Hungary was not transparent and operated dysfunctionally.

Essential changes have taken place in the economy during the transition, with radical alterations in the ownership structure and the wage and price systems. Hungary approaches much more closely to the "normal state" in a consolidated market economy. This study has tried to show that, in spite of the considerable improvements in the operation of the housing market, the present system of housing subsidies is still open to several criticism. Although the volume of subsidies has (rightly) fallen, the subsidy system bears the legacy of the past, it is still not transparent.

Appendix

Table A1

Rent-level estimates for Hungary

Rent level	Method of estimation	Year	Calculated per actual rent
Actual rent (Dániel)	HBS data	1989	1.0
Estimated market rent (Dániel)	actual rent plus on and off-budget subsidy	1989	8.5
Estimated market rent (Hegedűs, Struyk and Tosics)	Estimates based on real estate brokers' information	1990	10.0
Imputed rent (Pudney)	Privatization based rent calculation	1992	5.4

Note: For more see Hegedűs, Struyk and Tosics (1991) and Pudney (1995).

Table A2

Change in incomes, rents and utility prices (percent)

Attribute	1989	1991	1993	1995
Disposable income	100.0	184.8	257.3	382.8
Consumer price index	100.0	174.0	262.3	399.2
Public housing. RNET/M^2	100.0	146.7	158.7	266.6
Coal briquettes	100.0	238.4	546.0	582.8
Domestic fuel oil	100.0	200.0	266.3	707.3
Hot water for district heating (m^3)	100.0	273.9	520.0	707.9
Electric energy	100.0	199.3	332.9	577.8
Mains gas	100.0	159.0	245.0	380.1
Mains water (Budapest)	100.0	425.4	1833.3	3316.0
Mains sewage (Budapest)	100.0	875.0	2337.5	4688.0

Note: National average water rates were 83 percent higher than the Budapest rate in 1993, and sewage rates were 42 percent higher.

Source: KSH, 1990 and 1996b.

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HUNGARY'S ACCESSION TO THE EU, COMPETITIVENESS AND TRADE[1]

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The purpose of this study is first, to examine whether or not the structure of Hungary's tariff protection before the association agreement with the EU was a handicap in the sectors in which the country had a comparative advantage and second, to detect and measure the effects of the tariff reduction on competitiveness and comparative advantages in Hungary (due to the forthcoming accession to the EU). For measuring the effects of tariffs on competitiveness a new index is introduced referred to as the "Burden on Competitiveness" (BOC) index. It was found that in most of the sectors that have been identified as the most important for the Hungarian economy the reduction of tariff rates on their inputs would be a major contribution to the increase of competitiveness. Furthermore, with regard to the second objective of the paper, it was found that the change in the tariff structure due to the accession to the EU will increase the competitiveness of the sectors in which Hungary has a strong comparative advantage.

1. Introduction

On 16 December 1991 Hungary signed an association agreement with the European Union (EU). Its free trade chapter entered into force on an interim basis on 1 March 1992 and the agreement entered fully into force after the ratification process on 1 February 1994.

The association agreement anticipated the elimination of all import duties and non-tariff barriers affecting industrial goods and gave selective concessions in the field of agriculture. Trade provisions were asymmetric, which means that the EU would abolish the trade barriers much faster than Hungary. A ten-year transitional period was granted to Hungary, and the EU opened its markets (except for some "sensitive" products like steel, some chemical products, textile and clothing, and agricultural products). At the Copenhagen Summit in June 1993 it was decided to accelerate the process of trade liberalisation. The EU has reduced the transitional period for the elimination of trade barriers on certain "sensitive" industrial products and reduced tariff and non-tariff measures on agricultural products earlier than planned.[2]

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[1] This study is part of a wider project on "The Effects of Tariff Structure Changes on Comparative Advantage and Resource Allocation in CEECs due to their Accession to the EU" funded by the Phare ACE programme (project P96-6170-R) of the European Commission (DG1a).

[2] For a detailed description of Hungary's relationships with the EU and the pattern of Hungary's foreign trade see *Kiss and Novak* (1998, pp. 104–122).

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Having recognised that the key feature of Hungary's trade policy is to reach full membership of the EU, this study has two purposes. First, to examine whether or not the structure of Hungary's tariff protection before the association agreement with the EU was a handicap in the sectors in which the country had a comparative advantage and second, to detect and measure the effects of the tariff reduction[3] on competitiveness and comparative advantages in Hungary due to the forthcoming accession to the EU. It proceeds as follows: section two describes the methodology used for measuring comparative advantages and the burden imposed on the competitiveness of a sector by the tariff structure of a country. For the latter a new index is introduced. Furthermore, the method used for measuring the effects of tariff structure changes on competitiveness is presented. Section three describes the data used, section four presents the results, and section five represents the conclusion.

2. Methodology for measuring comparative advantages and competitiveness

2.1. The Revealed Comparative Advantage index

In the relevant professional literature several indexes have been devised to measure relative competitive strength and specialisation, and their changes as conditions change. However, the indicator that is probably best known and most often used to measure comparative advantages is the Balassa or *Revealed Comparative Advantage* (RCA) index.

Balassa (1965, 1977, 1988) suggested an index which, he claimed, takes into account all factors that influence a country's pattern of trade. This index is referred to as the "revealed" comparative advantage index because it is based on *all the factors* that influence comparative advantage which are reflected in trade flows, without having to examine them separately, or even to account for them.

The method arose from the difficulties encountered in measuring comparative advantage between the different industries of different countries.

The first difficulty comes from the elasticity of substitution between the factors of production (Balassa 1965, pp. 100–103). In a Heckscher-Ohlin-Samuelson (H-O-S) trade model, if the elasticity of substitution between the factors of production is zero (in the two-factor model), the relative factor intensities of individual commodities will be uniquely determined and the international specialisation will

[3]The Association Agreement covers not only tariff reductions but also non-tariff impediments to trade. The fees (i.e. licensing fee, customs clearance and statistical fee), with the equivalent effect on tariffs applied by Hungary should be abolished according to that Agreement. The timetable is set for the period between 1995 and 1997. Moreover, quantitative restrictions should be abolished by 2001. The work covered by this study does not examine the effects of non-tariff measures and focuses only on the effects of tariff reduction.

correspond with inter-country differences in factor endowments. With the introduction of demand—which reflects the differences in tastes—into the model, relative factor endowments can be expressed in terms of relative factor prices. This means that the country with the lower relative price of one factor will be considered as abundant in that factor. However, in practice, elasticities of substitution are rarely zero[4] and they also differ among industries and, consequently, relative factor intensities are not independent of factor prices. If the price of one factor rises relative to the price of the other factor, the intensity of the factor whose price did not rise in the industry with the higher elasticity of substitution will increase relatively to the industry with the lower substitution elasticity. If the latter industry had used the factor whose price did not rise more intensively before the price increase, a switch in factor intensities might occur (depending on the magnitude of the difference between the elasticities of substitution of the two industries) and relative factor endowments will not determine uniquely comparative advantage.

A further difficulty, apart from the possibility of factor-intensity reversals, is that a calculation of direct plus indirect factor coefficients will not provide an appropriate indication of comparative advantage if inter-country differences in efficiency exist. If these differences are the same in all industries of a country in relation to the industries of the other country then the country with a higher level of efficiency will possess advantages in industries that use in their production processes intermediate products in larger quantities. Therefore, direct factor requirements should be considered separately from intermediate inputs when inter-country differences regarding intermediate products reflect relative efficiencies in the intermediate stages of production (*ibid*, p. 101).

Difficulties also arise if more than two production factors are considered. If it is assumed that factor-intensity reversals do not exist, a unique ranking of industries according to their relative factor intensities could be made in the case of the two factors. However, if more than two factors are introduced a unique ranking may be possible only with regard to pairs of factors. Furthermore, if the production process uses intermediate commodities, the latter cannot be considered as homogeneous inputs in the calculation of comparative advantage since the comparative advantages of these industries will also depend on the number of the preceding stages of transformation. A further increase in the difficulties involved in establishing a unique ranking of industries will occur if the differences in natural endowments are considered, since they will cause a further increase in the number of production factors.[5]

[4] The elasticity of substitution between the two factors of production could be infinity without causing any problems, but in that case the two factors would be perfect substitutes and they could be considered as one factor of production.

[5] For a summary of the difficulties arising in the tests of the H-O-S theory see *Deardorff* (1984, pp. 478–493).

Therefore, given the difficulties that arise from the introduction of many factors of production, the inter-country differences in efficiency among countries and further the introduction of many countries, H-O-S theory might not be an easy tool to use in evaluating comparative advantages.

On the other hand, inter-country differences in the efficiency of individual industries can be allowed by the classical theory of comparative advantage when data on labour productivity have been used as an approximation of efficiency. Yet difficulties also arise with the use of standard assumption classical theory in calculating comparative advantage, since the number of production factors is usually greater than one.[6]

Furthermore, non-price factors sometimes influence the pattern of international trade among countries and they are neglected in theoretical discussions and empirical studies. Cost considerations alone would not be able to explain the trade pattern of a country, since quality differences, tradition, or even the reputation of that country in the production of some commodities also influence the pattern of its foreign trade. Therefore, a complete explanation of comparative advantage should also take into consideration the non-price variables.

Additionally, international trade flows are influenced by other, non-economic factors, such as social and political factors; these cannot easily be incorporated in a trade model. "Comparative advantages appear to be the outcome of a number of factors, some measurable, other not, some easily pinned down others less so" (Balassa *op.cit.*, p. 116).

The difficulties encountered in measuring comparative advantage can be summarised as:

— difficulties in accounting for all the economic factors which influence an industry's comparative advantage,

— difficulties in measuring and comparing the above factors between countries and industries,

— difficulties in accounting and measuring non-economic factors, of a socio-political nature, which influence comparative advantage but are not easily recognisable and measurable.

Nevertheless, policy-makers have to know the degree of advantage exhibited by a particular country over various goods and, if many countries are under examination and trading the same goods, the degrees of advantage exhibited by these countries with respect to a particular traded good. This obviously is necessary for a country in order to recognise, and then meet or plan successfully, any trading options it might have with other countries. An answer to these questions could be found if "instead of enunciating general principles and trying to apply these

[6]Most empirical studies of comparative advantage now identify more than two factors of production, mainly by considering different types of capital and labour and allowing for the existence of natural resources [e.g. *Harkness* (1978) identified 16 different factors of production in his study].

to explain actual trade flows, one took the observed pattern of trade as a point of departure, and subsequently attempted to find the main influences that have determined the pattern" (*ibid*, pp. 116–117).

Therefore, instead of explicitly taking into account all influences that determine comparative advantage, it would appear sufficient to provide information on "revealed" comparative advantage; moreover, the apparent or revealed performance of an industry's trade pattern would serve as an adequate indicator of that industry's "revealed" comparative advantage in international trade.

The "revealed" comparative advantage method reflects costs of production as well as non-price factors in an industry's operations. It should be made clear though that, in accordance with the above, the method of "revealed" comparative advantage provides information about the *consequences* and not the *causes* of a comparative advantage enjoyed by the country under examination.

For the calculation of the Revealed Comparative Advantage index for an industry j the Balassa formula will be used (Balassa 1965, 1977, 1988):

$$RCA_j = \frac{(X_j - M_j)}{(X_j + M_J)} \cdot 100;$$

where j is the input-output sector j, and X_j and M_j are, the respective values of *total* exports and imports to / from all countries of sector j for the given year.

The above formula uses net exports normalised by the ratio of the sum of exports and imports of the country in each sector in order to exhibit the comparative advantage of a sector. A country's net exports in each commodity category are the theoretical correct measure of comparative advantage (Deardorff 1980, 1982).

It is clear that $-100 \leq RCA \leq 100$, and that when exports grow faster than imports there will be a positive change in RCA, indicating an increase in relative comparative advantage. In the professional literature the values of RCA are such that $100 \geq RCA > 0$ are considered broadly as indicating strong relative competitiveness, whilst values such that $0 \geq RCA \geq -100$ are considered as indicating weak relative competitiveness.

It should be mentioned here that if a country is revealed by the index to possess a comparative advantage in exporting a commodity, this does not necessarily mean that its comparative advantage lies with the production of that commodity. All that the "revealed" comparative advantage indexes say is that a country has a comparative advantage or disadvantage in exporting a commodity. This advantage may arise from either or both production and consumption.

2.2. The "Burden On Competitiveness" Index.

A new index is introduced named "burden on competitiveness" (BOC), in an attempt to measure the effects of the tariff structure of a country on the competitiveness of a sector in international markets. (See also *Tsounis* 1998, pp. 1–31.) The BOC index shows how much higher the domestic cost of intermediate inputs for the final product producer is than the cost of the same quantity of intermediate inputs at international prices. Domestic producers selling abroad receive the price prevailing on the international market. However, they have to produce at an increased cost since they have to buy intermediate inputs in the domestic market, thus paying the tariff imposed on them. The index for sector j is calculated using the following formula:

$$BOC_j = \frac{\sum_i X_{ij} - \sum_i \frac{X_{ij}}{1+t_i}}{\left[X_j \frac{d_j}{1+t_j} + X_j(1-d_j)\right] - \sum_i \frac{X_{ij}}{1+t_i}} \cdot 100;$$

where X_j is the value of output at domestic market prices, X_{ij} is the domestic value of the ith input into the jth output, t_j and t_i represent the nominal tariff rate on j and i respectively, j and i denote the final product sector j and the input sector i, respectively and d_j is the proportion of output that is sold domestically by sector j.

The nominator represents the total amount that domestic producers of industry j have to pay due to the imposition of tariffs on intermediate inputs used in the production process of j. The denominator is the value added to sector j at world prices and it is used in the index for normalisation purposes.

In addition, in the denominator, to find the value to added to the sector at world prices, allowance is made for the fact that most sectors may be both importing and exporting at the same time. The assumption is that the output of an exporting sector is sold abroad at the free trade price but is sold domestically at the protected price. Hence, the producing sector *receives protection only on that portion sold in the domestic market*, while the using sectors are taxed by the full amount of the tariff. Therefore, if d_j is the proportion of output that is sold domestically by sector j, the output sold abroad is $X_j(1-d_j)$. The latter is sold at world prices and, according to the above, should not be deflated by the tariff. (For more on this issue see Tsounis 1992, pp. 173–176.)

It is clear that $0 \leq BOC_j$, since the value of intermediate inputs to a sector could not be less than the value of the same inputs at international prices. $BOC_j = 0$ when none of the inputs to the sector j receive tariff protection.

2.3. The method for measuring the effects of tariff structure changes on competitiveness

As stated in the introduction, the scope of this study is to examine first, whether or not the structure of Hungary's tariff protection before the association agreement with the EU was a handicap in the sectors in which the country had a comparative advantage; second, to detect and measure the effects of the tariff reduction on competitiveness and comparative advantages in Hungary due to the forthcoming accession to the EU. In the paragraphs below the methodology followed for achieving the above objectives is presented.

To examine whether or not the pre-association structure of tariff protection was a handicap in the sectors in which the country had a comparative advantage, both qualitative analysis and non-parametric statistics will be used. The latter method involves the correlation of the pre-association RCA indexes with the pre-association BOC indexes. If sectors with high RCA index values also present high BOC index values then the structure of tariff protection of the country can be regarded as a handicap for the sectors in which the country had a comparative advantage. The former method—i.e. of qualitative analysis—consists of the identification of "important" sectors for the economy and analysis of their pattern of tariffs imposed on intermediate inputs. Further identification of sectors with high BOC indices and a strong comparative advantage will be made in order to examine whether the sectors with a strong comparative advantage were being penalised by Hungary's pre-association tariff structure.

For the estimation of the effects of the tariff reduction—due to Hungary's accession to the EU—on its structure of comparative advantage and competitiveness, the pre-association RCA indexes will be correlated with the change in the burden on competitiveness (BOC) that will occur after accession to the EU. If the sectors with high RCA index values present a high reduction in the BOC then the structure of comparative advantage is reinforced by the tariff reduction due to the accession.

3. Data description

In the analysis, the data of the input-output (I/O) table for 1991 for the Hungarian economy has been used. This was the most recent detailed input-output table showing high sectoral disaggregation. Input-output data is available after 1991 but these include 21 sectors which were not suitable for the analysis in this study. Furthermore, there is another reason which supports the choice of this year. In 1992 the free trade chapter of the Association Agreement between Hungary and the European Union came into force. The latter resulted in substantial average tariff cuts[7] for the imports from the EU. Under these circumstances, using data from a year after 1991 would cause significant distortions in the calculation of the accession effects.

However, the use of 1991 data has the following problem. The year 1991 is of particular importance in the process of the renewal of the Hungarian statistical system; it was the last time that the companies had to make the same financial reports as before. In that year the method used by the customs statistics in the foreign trade data was changed, and it was in 1992 when the new Standard Industrial Classification of All Economic Activities was introduced. This means that export-import data and the classification of production is very difficult to compare for the two periods, before and after 1991.

From the input-output table 69 sectors were identified. Production, export and import data were reported as well as indirect taxes on domestic production and import taxes. Indirect taxes were calculated as a balance of taxes on product and production, minus subsidies. The weighted average tariff rate calculated from the I/O data is approximately 8.5, which can be compared with the weighted tariff rate calculated from the official nominal tariff rates. In addition, calculating the total collected tariffs according to I/O table rates, results similar to the data found in the balance sheet of the national government for 1991 have been obtained. Therefore, it was decided to accept the tariff rates of the I/O table, since they are in agreement with the official nominal rates and the data from the national accounts.

As stated in the introduction, one of the aims of this study is to detect and measure the effects of the tariff reduction on competitiveness and comparative advantages in Hungary due to the forthcoming accession to the EU. In order to find, the tariff structure that will prevail in Hungary after the accession to the EU the most acceptable method would have been to use the Common External Tariff rates of the EU and to calculate a weighted average nominal tariff rate for each of the I/O sectors. However, the Common External Tariff rates could not be used since the categories are very different from those of the I/O table of Hungary for 1991. Instead of that, the "control country" approach has been used and for the calculation of the post-accession tariff structure (*ex-ante* tariffs) the Greek tariff rates have been used. This is because, in their nomenclature they could be harmonised with the Hungarian categories. An implicit assumption for using the "control country" approach for the calculation of *ex-ante* tariff rates is that the commodity composition of the imports of a Greek input-output sector is the same as the commodity composition for the corresponding sector of Hungary's input-output table. The latter might create some errors in the calculation of Hungary's

[7] Imports from the EU were divided into three categories: products of a "fast list", products of a "normal list" and products of a "slow list". Products of the "fast list" had zero tariff rates by 1 January 1994.

post-accession tariff rates but the creation of an *anti-monde* is not an error-free procedure and, given the data availability, this was the only feasible solution.

4. The results

To examine whether or not the pre-association structure of tariff protection was a handicap in the sectors in which the country had a comparative advantage, in the first instance non-parametric statistics will be used. The method consists of correlating the pre-association RCA indexes with the pre-association BOC indexes. If sectors with high RCA index values also present high BOC index values then it can be concluded that Hungary's structure of tariff protection was a handicap for the sectors in which the country had a comparative advantage.

Based on the input-output table sectoral data, the revealed comparative advantages of Hungary for 1991 have been calculated and the results are presented in *Table 1*. Among the 69 sectors examined, the RCA index was positive in 44 cases. Hungary showed very strong comparative advantages (RCA indices between 70–95) in meat, poultry, dairy products, sugar, baking, vegetable oil and wine industry, furniture and rail transport. Strong advantages (RCA between 50–70) were found in beers and spirits, canning industry, textile clothing, other wood processing, leather manufacture and aluminium casting, manufacture of glass and ceramics, and the manufacture of machinery and transport equipment. Significant advantages were shown also in the manufacturing of electrical equipment, instruments and telecommunication equipment, knitted articles, plastics, rubber, pharmaceuticals and footwear.

As a second step, the "burden on competitiveness" index (BOC) was calculated and the results are also presented in *Table 1*. If sectors with a comparative advantage (i.e. with high RCA index values) also show high BOC index values, then the structure of tariff protection was unfavourable for the sectors where Hungary had comparative advantages. In this case a strong positive correlation should exist between the ranking of the RCA and BOC indices. The Spearman rank correlation coefficient shows the correlation between the ranking of two series and, in this case, between the ranking of sectors with RCA and the ranking of sectors with BOC. The value of the coefficient was -0.108, which means a rather small negative correlation. Thus, it could be concluded that, overall, the structure of tariff protection in Hungary was not a handicap for the sectors in which the country had a comparative advantage. The structure of the tariff burden on the competitiveness of the respective sectors ranking with the comparative advantages of the sectors.

In order to examine whether or not the structure of tariff protection was a handicap in those specific sectors in which Hungary had a comparative advantage, and which are considered important for the Hungarian economy, qualitative analysis

Table 1

Gross output, revealed comparative advantages, burden on competitiveness, ex-ante (post-accession) BOC indices for Hungary and change in the burden on competitiveness after accession

Sec. No.	Sectoral description	Gross output HUF million	RCA	BOC	Ex-ante BOC	Change in BOC
1	Coal mining	45,587	−99.87	1.98	0.21	−1.767
2	Crude oil and natural gas mining	69,620	−87.57	9.14	0.03	−9.113
3	Mining of Bauxite	4,217	31.65	1.52	0.18	−1.345
4	Mining of other ores and minerals	3,835	46.48	1.64	0.17	−1.468
5	Production. collection and distribution of electricity	160,022	−99.94	4.62	0.20	−4.419
6	Manuf. and casting of basic iron and steel	90,369	19.00	5.08	0.69	−4.388
7	Manuf. and casting of aluminium	46,648	51.64	4.97	0.62	−4.346
8	Manuf. and casting of other non-ferrous metals	9,961	5.66	0.73	0.05	−0.677
9	Manuf. of machinery and equipment	127,664	54.48	2.71	0.44	−2.271
10	Manuf. of transport equipment	87,067	53.09	3.69	0.60	−3.093
11	Manuf. of electrical machines and appliances	60,636	41.42	4.17	1.95	−2.222
12	Manuf. of telecommunications and vacuum technique products	50,528	45.38	2.31	0.76	−1.554
13	Manuf. of instruments and appliances	45,820	22.49	1.86	0.35	−1.508
14	Iron and metal mass production	66,577	40.37	1.91	0.32	−1.586
15	Manuf. of bricks, tiles and refractory materials	9,435	21.33	3.56	2.45	−1.105
16	Quarrying of stones and gravel	4,324	52.77	1.91	0.46	−1.452
17	Manuf. of lime and cement	11,909	−40.06	9.69	1.95	−7.741
18	Manuf. of concrete articles	9,772	−16.91	7.38	6.79	−0.588
19	Manuf. of asbestos cement	1,572	−60.97	4.11	5.01	0.902
20	Manuf. of insulating materials for construction	5,216	−13.04	4.66	1.90	−2.764
21	Manuf. of fine ceramics and grinding wheels	9,078	64.07	1.58	0.53	−1.049
22	Manuf. of glass	17,496	69.92	8.95	1.11	−7.842
23	Crude oil processing	142,269	−59.99	7.99	0.01	−7.983
24	Production and distribution of gas	75,024	−96.00	19.62	0.05	−19.57
25	Manuf. of organic and inorganic chemical products	56,208	6.27	2.98	0.27	−2.708
26	Manuf. of fertilisers and plant-protecting agents	22,258	−2.67	5.32	0.36	−4.963
27	Manuf. of plastic materials and synthetic fibres	43,383	34.95	1.64	0.20	−1.437

Table 1 *(continued)*

Gross output, revealed comparative advantages, burden on competitiveness, ex-ante (post-accession) BOC indices for Hungary and change in the burden on competitiveness after accession

Sec. No.	Sectoral description	Gross output HUF million	RCA	BOC	Ex-ante BOC	Change in BOC
28	Processing of synthetic materials	40,069	9.25	5.82	0.81	−5.014
29	Manuf. of rubber articles	16,233	37.21	1.80	0.28	−1.519
30	Manuf. of pharmaceutical products	64,349	22.40	1.52	0.21	−1.311
31	Manuf. of household chemicals and cosmetics	16,142	−42.79	6.55	0.95	−5.604
32	Sawmilling and manuf. of plywood	12,498	39.10	2.97	0.74	−2.235
33	Carpentry and joinery for construction	12,725	6.55	2.59	0.76	−1.830
34	Manuf. of furniture and repair of wooden products	30,874	92.41	1.91	0.78	−1.131
35	Other wood processing	8,711	58.17	1.77	0.82	−0.954
36	Manuf. of paper products	36,483	−46.54	1.97	0.28	−1.690
37	Printing	31,780	−26.78	2.45	0.20	−2.251
38	Cotton production	20,268	−13.15	1.99	0.30	−1.687
39	Flax, hemp and jute production	2,529	55.66	3.85	1.17	−2.679
40	Wool production	8,834	−6.54	2.10	0.40	−1.697
41	Silk production	2,624	−29.27	7.12	0.64	−6.478
42	Manuf. of small ware	19,789	−9.54	2.80	0.36	−2.436
43	Manuf. of knitted articles	13,281	42.97	4.42	0.60	−3.825
44	Manuf. of leather and fur	12,882	50.99	2.69	0.96	−1.733
45	Manuf. of footwear and repair of leather, fur and footwear	20,159	42.93	1.93	0.77	−1.158
46	Textile clothing	44,368	59.07	1.59	0.23	1.364
47	Manuf. of handicrafts	4,186	55.29	0.99	0.35	−0.638
48	Manuf. of other products	25,704	82.84	1.30	0.48	−0.825
49	Meat industry	100,433	92.37	14.42	15.90	1.477
50	Poultry and egg processing industry	36,911	93.99	11.91	14.97	3.059
51	Dairy industry	49,658	77.18	16.48	13.69	−2.794
52	Canning industry	69,832	64.32	7.55	3.94	−3.614
53	Milling industry	53,772	−20.99	6.82	7.35	0.533
54	Baking	30,478	73.76	3.85	1.52	−2.330
55	Sugar industry	21,846	85.88	7.81	8.21	0.401
56	Confectionery industry	26,558	21.85	4.47	0.85	−3.623
57	Vegetable oil industry	16,027	76.99	6.23	7.99	1.756
58	Spirits industry	14,358	66.46	8.97	3.22	−5.746
59	Wine industry	13,220	83.19	5.09	1.98	−3.111
60	Beer industry	20,010	−77.97	4.70	1.74	−2.962
61	Production of soft drinks and mineral water	9,613	−24.52	11.74	1.53	−10.209

Table 1 *(continued)*

Gross output, revealed comparative advantages, burden on competitiveness, ex-ante (post-accession) BOC indices for Hungary and change in the burden on competitiveness after accession

Sec. No.	Sectoral description	Gross output HUF million	RCA	BOC	Ex-ante BOC	Change in BOC
62	Tobacco industry	14,072	−77.20	6.27	1.23	−5.038
63	Construction	321,636	16.18	3.73	2.18	−1.545
64	Agriculture	521,032	39.05	3.17	3.40	0.234
65	Forestry	22,689	−44.32	4.52	0.32	−4.196
66	Rail transport	66,482	73.36	0.97	0.19	−0.785
67	Transport y roads and urban transit	123,465	18.56	0.96	0.16	−0.803
68	Other transport	46,410	0.28	0.46	0.03	−0.427
69	Post and telecommunications	59,171	−34.75	0.18	0.02	−0.163

was used. This consists of the identification of "important" sectors for the economy and an analysis of the pattern of their tariffs that is imposed on intermediate inputs. A second method of qualitative analysis consists of the identification of sectors with high *BOC* indices and strong comparative advantage. This identification will be made in order to examine whether the sectors with strong comparative advantage were being penalised by Hungary's pre-association tariff structure.

When applying the first of the above methods of qualitative analysis, the 69 sectors of the I/O table were examined in order to identify important sectors of the Hungarian economy. In this process, the *RCA* indices and gross output of the sectors (*Table 1*) were taken in to account.

From the 69 sectors, 5 were selected. The selection was based on three major criteria:

1. the share of the given sector in gross production (the gross production of each sector is given in *Table 1*),
2. the revealed comparative advantage index,
3. the changes in recent years—namely, the direction of changes in production and *RCA* indices over the past 6 years.

On the basis of the above criteria the following sectors were identified as important for the Hungarian economy:

1. Manufacture of machinery and equipment (9)
2. Pharmaceuticals (30)
3. Manufacture of transport equipment (10)
4. Manufacture of electrical machines and appliances (11)
5. Textile clothing (46)

Next, an analysis of the tariff structure of their intermediate inputs was made[8] and the average weighted tariff rates for the "important" sectors were calculated. These are: for the manufacture of machinery and equipment sector (9) 10.971 percent; for the pharmaceuticals sector (30) 7.228 percent; for the manufacture of transport equipment sector (10) 13.647 percent; for the manufacture of electrical machines and appliances sector (11) 13.138 percent; and for the textile clothing (46) sector 8.963 percent.

Given these rates, the intermediate input composition of the respective sectors was compared in order to find those inputs which contribute most to the production of a given sector.

The most important ten intermediate inputs that, to a large extent, influence the price of the final product and its competitiveness can be identified for each of the "important" sectors of the Hungarian economy.

For the sector "manufacture of machinery and equipment" (9) the ten most influential input sectors account for around 70 percent of the final product. From the data it can be seen that the tariff structure is mostly favourable, but three important sectors—contributing 31.9 percent to the final product (sectors 6, 10, 11)—have above average tariff rates. The reduction of tariff rates in these three sectors would represent a major contribution to increasing the competitiveness of the manufacture of machinery and equipment sector.

For the pharmaceuticals sector (30) the ten most influential input sectors contribute about 60 percent to the final product. The conditions for the production of pharmaceuticals are quite unfavourable. From among these the most important intermediate seven sectors have above average tariff rates. These are sector 25 (manufacture of organic and inorganic chemical products), sector 30 (manufacture of pharmaceutical products), sector 63 (construction), sector 36 (manufacture of paper products), sector 13 (manufacture of instruments and appliances), and sector 28 (processing of synthetic materials).

In the sector for the manufacture of transport equipment (10), the situation is quite favourable, since the tariff rates in the most important intermediate input sectors are lower or equal to the sectors' average tariff rate. However, the average rate for the sector is very high, compared to the average tariff burden on the total economy.

For the sector for the manufacture of electrical machines and appliances (11), the most influential sectors encompass about 74 percent of total intermediate inputs. Above average tariff rates were found in one sector—namely, the processing of synthetic materials (28). Therefore, in sector 11, the situation is close to neutral or slightly unfavourable.

[8]The value of the intermediate inputs and the tariff rates for the above "important" sectors are not reported here for reasons of space. They are available upon request from the authors.

Finally, in the sector for textile clothing (46) the ten most influential sectors constitute about 83 percent of total intermediate inputs. Above average tariff rates are applied in the five most important sectors. These are cotton production (38), construction (63), silk production (41), manufacture of small goods (42) and manufacture of knitted articles (43). Therefore, in the sector for textile clothing the tariff structure of the intermediate inputs is rather unfavourable and quite significant changes are required in order to improve its competitiveness.

As already mentioned above, the second method of qualitative analysis consists of the identification of sectors with high *BOC* indices and strong comparative advantage. This makes it possible to examine whether the sectors with strong comparative advantage were being penalised by Hungary's pre-association tariff structure.

From *Table 1* the *RCA* and *BOC* indices have been collected and the sectors with high *RCA* and *BOC* indices have been identified.

Among the 69 sectors examined, the *RCA* index was positive in 44 cases. Hungary showed very strong comparative advantages (*RCA* indices between 70–95) in meat, poultry, dairy products, sugar, baking, vegetable oil and the wine industry, and furniture and rail transport. Strong comparative advantages (*RCA* between 50–70) were found in spirits, the canning industry, textile clothing, other wood processing, leather manufacture and aluminium casting, the manufacture of glass and ceramics, the manufacture of machinery and transport equipment. Significant advantages were also shown in the manufacture of electrical equipment, instruments and telecommunications equipment, knitted articles, plastic, rubber, pharmaceuticals and footwear.

The average *BOC* index for the year 1991 was 4.852. Thus the *BOC* index of a sector was considered high if its value exceeded 4.852. *RCA* indices were considered to be high above 50, and comparative advantage was very strong if the *RCA* index of a sector was above 70. After examining sectors in which the *RCA* index value was higher than 50, the sectors having above average *BOC* indices were selected.

These sectors, ranked according to the value of *BOC* are the following: dairy industry (51), meat industry (49), poultry and egg processing industry (50), processing of synthetic materials (28), manufacture of glass (22), sugar industry (55), canning industry (52), vegetable oil industry (57), wine industry (59), and the manufacture and casting of aluminium (7).

In order to propose a set of tariffs with the aim of bringing about significant decreases in the *BOC* indices, the input structure of these sectors has to be analysed. From the input-output table the contribution of intermediate input sectors were found. The sectors with high *BOC* indices were also found. An analysis of the two most important input sectors from among the sectors with high *BOC* indices in fact represents quite a good means for proposing tariff rates for intermediate inputs; this would reduce *BOC* indices to a large extent.

The intermediate inputs that contribute considerably to the production of the final product of the "important" sectors for the Hungarian economy are the following: for sector 51 (dairy industry) the important intermediate sectors are 64 (agriculture) and 28 (processing of synthetic materials); for sector 49 (meat industry) the important intermediate sectors are 6 (manufacture and casting of basic iron and steel) and 64 (agriculture); for sector 50 (poultry and egg processing industry) the important intermediate sectors are 64 (agriculture) and 5 (production, collection and distribution of electricity); for sector 28 (processing of synthetic materials) the important intermediate sectors are 27 (manufacture of plastic materials and synthetic fibres) and 5 (production, collection and distribution of electricity); and for sector 22 (manufacture of glass) the important intermediate sectors are 24 (production and distribution of gas) and 2 (crude oil and natural gas mining). If the tariff rates for the above intermediate inputs were reduced then the BOC index would be reduced significantly.

The final objective of this study is the estimation of the effects of the tariff reduction—due to Hungary's accession to the EU—on its structure of comparative advantage and competitiveness. As already mentioned in section 2.3, the methodology followed for achieving this task involved a correlation of the pre-association RCA indexes with the change in the burden on competitiveness (BOC). If the sectors with high RCA index present a high reduction in BOC then the structure of comparative advantage is reinforced by the tariff reduction due to the accession.

For the examination of the tariff structure and its changes after the accession to the EU, the use of the Common External Tariff rates would have been the best solution. However, these do not confirm with the sectoral structure of the Hungarian input-output table. Therefore, as a second best solution, as explained in section 3, the "control country method" has been applied for the construction of the *anti-monde* and the *ex-post* (after the completion of the Single Market Programme in 1992) tariff rates of Greece since the nomenclature used by the two countries was similar. Using these rates the *ex-ante* burden on competitiveness—i.e. the burden on competitiveness that will prevail after Hungary's accession to the EU—was calculated and then the change in the burden on competitiveness due to tariff reduction concomitant with accession to the EU was computed (*Table 1*).

The rankings of the differences between the pre-accession and *ex-ante* BOC index (thus the reduction in BOC index) were correlated with those of the RCA index, and the Spearman rank correlation coefficient was calculated. The value of the coefficient is negative (-0.363) and it is statistically different from zero at a 1 percent level of statistical significance ($p = 0.0028$). The latter means that sectors with high RCA index values will experience a large change in the burden on competitiveness (BOC) index after the accession to the EU and thus their comparative advantage will be reinforced. Therefore, the change in the tariff structure after accession to the EU will increase the competitiveness of the sectors in which Hungary has a strong comparative advantage.

5. Conclusions

The first aim of this study was to examine whether or not the structure of Hungary's tariff protection before the association agreement with the EU was a handicap for those sectors in which the country had a comparative advantage. The second aim was to detect and measure the effects of the tariff reduction on competitiveness and comparative advantages in Hungary due to the forthcoming accession to the EU.

In order to examine whether or not the pre-association structure of tariff protection was a handicap in those sectors in which Hungary had a comparative advantage non-parametric statistics and qualitative analysis were used first. Using this first method it was found that overall, the structure of Hungary's tariff protection was not a handicap to those sectors in which the country had a comparative advantage. The structure of the tariff burden on the competitiveness of the sectors was not concomitant with the comparative advantages of the sectors. Qualitative analysis was used to examine whether or not the structure of tariff protection was a handicap in specific sectors in which Hungary had a comparative advantage and which are considered important for the Hungarian economy. This consisted of the identification of "important" sectors of the economy and analysis of the pattern of tariffs they impose on intermediate inputs. A second method of qualitative analysis consisted of the identification of sectors with high *BOC* indices and strong comparative advantage. This made it possible to examine whether the sectors with strong comparative advantage were being penalised by Hungary's pre-association tariff structure.

By applying the first method of qualitative analysis, five sectors were identified as the most important for the Hungarian economy: namely, manufacture of machinery and equipment, pharmaceuticals, manufacture of transport equipment, manufacture of electrical machines and appliances and textile clothing. The reduction of tariff rates in the manufacture and casting of basic iron and steel, the manufacture of transport equipment and the manufacture of electrical machines and appliances would have made a major contribution towards increasing the competitiveness of the manufacture of machinery and equipment. The conditions for the production of pharmaceuticals were found to be quite unfavourable. The reduction of tariff protection would have increased competitiveness in the sectors for the manufacture of organic and inorganic chemical products, the manufacture of pharmaceutical products, construction, the manufacture of paper products, the manufacture of instruments and appliances and the processing of synthetic materials. In the sector for the manufacture of transport equipment, the situation was quite favourable, since the tariff rates in the most important intermediate input sectors were lower or equal to the sectors' average tariff rate. However, the average rate for the sector is very high, compared to the average tariff burden on the total economy. For the sector for the manufacture of electrical machines and appliances it was found that the decrease of tariff protection in the sector for the processing of synthetic materials would have increased the competitiveness of the sector. Finally, for the sector of textile clothing the tariff structure of intermediate inputs was rather unfavourable and quite significant changes were required in order to improve its competitiveness. The reduction of tariff protection in five sectors—cotton production, construction, silk production, the manufacture of small ware and manufacture of knitted articles—would have significantly improved the competitiveness of those sectors.

By applying the second method of qualitative analysis the sectors with high *RCA* and *BOC* indices were identified. These sectors are: the dairy industry, meat industry, poultry and egg processing industry, the processing of synthetic materials, the manufacture of glass, sugar industry, canning industry, vegetable oil industry, wine industry and the manufacture and casting of aluminium. An analysis of the most important ten inputs of these sectors provided a means for proposing tariff rates for intermediate inputs, which would significantly reduce *BOC* indices. Therefore, if the tariff rates for the most important inputs (especially for the most important 2–3 input sectors) were reduced, the *BOC* index would be decreased considerably.

The second objective of the study was to estimate the effects of tariff reduction—due to Hungary's accession to the EU—on its structure of comparative advantage and competitiveness. The methodology followed for achieving this task is the test for the correlation between pre-association *RCA* indexes and the change in the burden on competitiveness (*BOC*) after accession to the EU. If the sectors with high *RCA* index values present a high reduction in *BOC* then the structure of comparative advantage is reinforced by the tariff reduction due to accession.

A negative—statistically significant from zero—rank correlation was found between the differences of the pre-accession and *ex-ante* (post-accession) *BOC* index and of the *RCA* index. This finding means that sectors with high *RCA* index values will experience a large change in the burden on competitiveness (*BOC*) index after accession to the EU and thus their comparative advantage will be reinforced. Therefore, the change in the tariff structure after accession to the EU will increase the competitiveness of the sectors in which Hungary has a strong comparative advantage.

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EUROPEAN INTEGRATION AND INSTITUTIONAL FRAGMENTATION: THE CASE OF THE POLISH TRANSPORT INDUSTRY

D. BOHLE

The author demonstrates that Europe is heading towards the emergence of a transnational integrated economy, in which national policies of deregulation are combined with the growing role of supranational institutions and in which new global market actors and new forms of market hierarchies are emerging. As Poland has not been capable of deploying the necessary resources for successful adaptation, a selective approach has been adopted and this works in favour of the needs of international transport while neglecting the restructuring of the domestic transport system. Thus a fragmented and dualistic transport regime has emerged in terms of its institutions and regulations, its geographical patterns, and its infrastructural developments. The article shows that the fragmented regime has created strikingly different firm structures, business and organisational strategies, and ultimately works in favour of multinational forwarding and logistic enterprises. The latter occupy strategic market segments in Poland, whereas the endogenous transport enterprises are in danger of being marginalised.

> "Membership of the European Union is the strategic aim of Poland. Integration with the Union will help to accelerate economic growth, modernise the economy and the legal system, and eliminate the technological gap between our country and other European Union countries. National interests explain the Polish determination to become a member of the Union."
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> (The Committee for European Integration, Warsaw, 1997)

1. Introduction[1]

Developments in the East European countries undergoing transformation have largely failed to follow the pathways set out in the blueprints of neoliberal reform designers. According to these blueprints, radical market-economic reforms were to accelerate the elimination of the state-socialist legacy, replacing it with a comprehensively reconstructed Western-style market economy. Despite the successes achieved since 1989 in privatisation, trade liberalisation and macroeconomic

[1] An earlier version of this essay was presented at the workshop on "Institution Building in the Transformation of Central and Eastern European Societies" organized by the E. S. F. Network on "Social transformations in Central and Eastern Europe", and also at the Central European University in Budapest, December 5–7, 1997. For very helpful comments and discussion on the earlier, as well as the recent draft, I am grateful to Christoph *Dörrenbächer*, Béla *Greskovits*, Anna *Leander* and Dieter *Plehwe*.

stabilisation, the development paths taken in the Central East European (CEEs) and East European countries reveal only a partial approximation to the Western model. Therefore, a number of evolutionary and institutionalist analysts of transformation suggest that instead of a convergence with the western pattern, the ex-socialist countries are heading towards a specific "Eastern capitalist" model (*Chavance and Magnin* 1995, 1997; *Delorme* 1995; *Grabher and Stark* 1997; *Stark and Bruszt* 1998).[2]

Evolutionary and institutionalist advocates of the path-dependency of economic development trace back the specificities of East European "capitalisms" to the state-socialist legacy of institutions, organisational forms and routines. They suggest that these have left their mark on current transformation processes, and thus can explain many specific features of the new capitalism subtype. In their view it is especially those institutions and organisations that emerged under the bureaucratic surface of the state-socialist system and compensated for its rigidities which may become valuable assets of economic development under post-socialism. Thus the patterns of a new order will emerge as a result of a process of recombination of the historical legacy with the new institutions promoted by current restructuring strategies. These patterns will be characterised by a certain degree of institutional incoherence and weakness, by hybrid forms of ownership, and the importance of informal economic activities.

The institutionalist approaches share the view that the nature of post-socialist transformation is unique and exceptional. Moreover, they implicitly or explicitly assume that the outcome of the process is mostly shaped by the variation of the *national* features of historical legacy, whereas they attribute only limited impact to the Western institutional system and the international economic trends. However, this implies their neglect of a central element of the transformation: (re)integration into the world economy in general, and into the framework of the European Union in particular. They seem to forget both about the goals of East European elites, who saw the liberalisation of foreign trade, currency and foreign investment regimes as an indispensable precondition for economic catching-up, and about the Western efforts to secure normative and institutional compatibility between the post-socialist transformation process, and the global world order. For a number of countries especially, adaptation to the standards of the European Union—including its intellectual and financial support—have provided the most important bridging mechanisms between their own reforms and the established norms and practices of the liberal world economy (*Kirk-Laux* 1994).

[2] The evolutionary and institutional literature on transformation incorporates more authors and different theoretical traditions. Whereas the above-mentioned authors can be said to be agenda-setting within the sociological debate, the economic discussion draws more on neo-institutional approaches (*Kornai* 1990; *Murrell* 1992, 1995; *Poznanski* 1996). I will however focus on the sociological debate.

Contrary to the evolutionary and institutional accounts of East European transformation, in my article I shall put the stress on the impact of international influence and constraints, and search for ways of analytically integrating these effects with those of the legacy of the past.[3] My starting point is that East Europeans, from the outset, have not constructed their emerging capitalism(s) in purely national contexts, but rather opted for immediate incorporation of their respective systems into what can be called a *process of transnational reorganisation of capitalism*. Therefore, while I share the institutionalist viewpoint that the fragmented and dualistic institutional system will remain a specificity of the "Eastern capitalisms", I mainly explain these features by the fact that they have tried to join the internationalised West as *late-comers*, and thus have had to bear the heavy risk and burden inherent in such an approach. Thus while their transformation is indeed unique in some respects, it exhibits similarities as well: i.e. with the efforts and weaknesses of other late-comers whose starting point was not state-socialism, and even with the most recent economic restructuring processes in Western Europe.

My study is based upon these considerations. In will show how the framework of the European Union and the competition of Western European economic actors have shaped the restructuring of the transport—and, specifically, the road haulage—industry in Poland. In *Section 2* I begin with a brief discussion of the basic features of the new European market regime, as it is becoming the main point of reference of the restructuring of the Polish transport industry. In *Section 3* I will show how Polish transport policy has gradually, but with much incoherence, adapted to this specific market regime, and which institutional consequences have been generated by the simultaneous process of transformation and adaptation. *Section 4* is devoted to the analysis of how the resulting fragmented regulatory and institutional system has shaped market structure and enterprise behaviour. I conclude with a brief summary of my findings, and a few conceptual suggestions.

2. The new European transport regime

The transport industry is not generally considered as being of central concern in the analysis of transformation. However, I chose this focus for my research because the transformation of the transport industry reveals central features which are not only significant for the changes at the sectoral level but because, at the same time it provides broader insight into the current changes in state-economy relations. *Voigt* (1973, Vol. I: 7f.) attributes several fundamental functions to the transport industry, out of which the following are of particular relevance for my study: 1) it is a part of any form of division of labour, and 2) it integrates state and society.

[3] There are other researchers who criticize the institutionalist approach for its lack of analysis of international forces in post-socialist transformation. My arguments are—at least partly—in line with *Hardy and Rainnie* (1996) and *Pickel and True* (1999).

As transport is not a clearly delimited and "independent" sector—rather, is locked into the organisation of production and distribution—the changes in this specific industry can serve as indicators for broader restructuring processes, and associated changes in the economic division of labour. Furthermore, a given transport system is never determined by economic factors alone—rather, it is strongly connected to political (and military) aims. Thus, the fordist (very much like the state socialist) transport regimes were as much determined by the economic need to transport goods as by the political goal of providing services in the public interest. The political determination of the transport system resulted in strongly regulated and state controlled transport regimes (see below). A fundamental process of change between the role of the state and private market actors within the field of the transport industry—which, according to *Strange* (1998: 137ff.), only occurs under conditions of political revolutions or fundamental technological changes—can be observed over the last 15–20 years. The dramatic shifts—associated with new transport technologies, innovations in the information and telecommunication sectors, the internationalisation of the industry, and the global reduction of transport costs—can be considered both as preconditions and as results of economic globalisation. In this way, the form of Poland's integration in global transport networks might be a good indicator of this country's general position in the international division of labour, and also show the extent of the transformation of the state-economy relation and, ultimately, of stateness itself.

The dual changes—i.e. the changes within the international division of labour and the redefinition of the relation between state and "the market"—are at the heart of the European integration project which was relaunched in the mid 80s; related to this, the creation of a single European transport market is of central importance. The transport industry—like other state, and infrastructure-related activities such as the telecommunications or the financial sector (e.g. *Esser et al.* 1997)—has been at the centre of the "regulatory reforms" and transnationalisation. These changes have become imperative, because the earlier transport regime of the European countries was tailored to the requirements and the structures of the *fordist model of economic development* which, from the late 60s, underwent a worldwide crisis. The fordist development, which was the path dominant in the Western capitalist world after World War II, can be characterised—in a highly stylised way—by a specific production paradigm (of taylorism, and the assembly line), and a mode of regulation allowing for intensive accumulation dependent on the growth of the domestic markets of standardised mass-products.[4]

The fordist transport regime meant autonomous *state regulation* within national borders and it relied on *state or quasi-state monopolies*—such as the national railway companies, or the national post offices—or *heavily regulated market regimes*

[4]By using the concepts of fordism and regulation, I am referring to the French Regulation School (*Aglietta* 1979, *Boyer* 1986, and *Lipietz* 1985).

for road transport. This guaranteed nationwide provision of standardised services, and strongly limited competition between the transport operators. This transport regime, in fact very similar to social policy regimes, aimed at the harmonisation of living- and competitive conditions within the country's territory. *Inter-national* transport regimes (in the literal sense of the word, meaning transport regimes agreed upon among sovereign national states) complemented the national transport systems. However, since the 1970s and 1980s—when, following the crisis of fordism, both production and accumulation became increasingly transnational—the strictly national organisation of transport has proved to become a major obstacle to the internationalisation and rationalisation strategies of industrial and trading firms.

In the EU, the Roundtable of European Industrialists, an association of some of Europe's largest and most influential multinational corporations, has vigorously argued for the unification of the European markets and this implies that a new transport regime is also needed. They have published several reports, starting with "Europe 1990: An agenda for action," (*ERT* 1984a) which proposed a five-year plan to eliminate trade barriers, harmonise regulations and abolish fiscal frontiers. Many of the propositions of this report can be found in the European Single Market project (*Sandholtz and Zysman* 1989; *Doherty and Hoedemann* 1994).

Thus it is no big surprise that, ever since the Milan Summit of 1985, deregulation and liberalisation of European transport markets have become central elements of the completion of the single market.[5] Within a few years the EU has indeed created the framework for an integrated and mostly privately organised transport system (*Plehwe* 1997).

The new neoliberal institutional structure has little in common with fordism. One of its characteristics is that, in place of former state or quasi-state national monopolies, *powerful private actors* have emerged and they organise the flow of goods on behalf of internationalised trading or industrial firms. As a consequence of intensified company mergers a *new hierarchy* is emerging on the market. The first wave of concentration in the transport industry mainly took place on a national scale, where the first internationally competitive logistic groups in Europe were forged. Since the mid-1990s, a second wave of mergers can be observed, this time including different European firms. An even more recent development is the reorganisation of postal markets, which has eventually led to the construction of five large transnational postal/parcel/logistic groups (Plehwe, 1997, 1999).[6] At the

[5] In fact, the aim of a common European transport policy was already laid down in the treaties of Rome, as was a common agricultural and trade policy. However, whereas in the field of agricultural policy a supranational market regime was established, transport policy remained under the control of the nation states up until the 1980s.

[6] The new hierarchy on the transport market is clearly at odds with the official discourse of neoliberal reformers. Whereas in this discourse it is stated that the liberalisation of market forces promotes growing competition and decentralisation of economic decisions, the experience gained so far shows that unfettered markets are above all a means of promoting economic concentration

opposite end of the scale, the increasingly transnational logistic and forwarding enterprises subcontract simple transport activities to smaller transport enterprises, regardless of their nationality.

Another new feature is that the capacity of the nation state to organise the transport system within its own boundaries is being overlapped, and partially substituted by *supranational EU regulations* which rely *on European institutions*. The Union enforces the rules of the liberal market regime, creates norms for minimal social and safety standards, and provides development programmes for infrastructure which allow for a veritable transnational integration. With regard to the latter, the European Union supports the creation of a *standardised transport infrastructure*. Ever since the Treaty of Maastricht, the so called Trans-European Networks (TENs) have been an important element of the EU's effort to provide efficient links between the diverse parts of the Union's territory. Similar to other measures aimed at the completion of the Single Market, the EU's infrastructure plans are politically backed by the European Roundtable of Industrialists. In a report titled "Missing Links", the group pointed out the shortcomings of European transport infrastructure (ERT 1984b, see also the follow up: ERT 1991). This report, as well as the group's active lobbying, paved the way for the EU programme of TENs. The TEN programme includes plans for 12,000 kilometres of new motorways by the year 2002, increasing the network by 32 percent, and for the modernisation of 23,000 kilometres of railway fitting for high speed rail. (*Europäische Kommission* 1996, p. 8)

To sum up: the new European transport regime differs strongly from its former fordist counterparts. It secures the European-wide empowerment of private market actors. As stated above, fordist transport policies were aimed at the homogenisation of living- and competition conditions *within the national territory*; however, these aims are now becoming subordinated under the ultimate goal of the new European transport regime, which is the enforcement of competitiveness *vis à vis* Europe's *external environment*. How, then, is this regime, and the related market forces, shaping the restructuring of the Polish transport industry?

3. The emergence of a fragmented transport regime in Poland

With reference to the reports on the details of the political and economic strategies in connection with the wider project of Poland's "Return to Europe", (*Belka et al.* 1997; *Hausner et al.* 1998) it should be noted that when Poland agreed to take on the "obligations of membership", the country stated her commitment to a) adapting to the whole body of EU legislation, known as the *acquis*

and centralisation.

communautaire, b) proving that Poland is a "functioning market economy" which c) has the "capacity to cope with competitive pressure and market forces within the Union" (these are the Copenhagen criteria for accession). With the further concretisation of the Copenhagen criteria in the Single Market White Paper (1995), and the Accession Partnership issued in 1998, the EU has in effect become a powerful and far-reaching agent of the Polish transformation and internationalisation process (*Grabbe* 1999).

Poland took her first step towards liberalising the transport industry as early as the beginning of 1989, independently of the EU.[7]

The "Law on economic activities" led to the almost complete abolition of the existing barriers to market entry for the greater part of the economy. With respect to road transport, this meant that literally anyone could offer national and international transport services. In the wake of this legal change, thousands of new companies were set up. In 1989 alone 45,000 new transport companies were founded, most of them very small firms with less than five employees (*Rydzkowski and Wojewodzka-Krol* 1995). By 1995 the number of such small firms had risen to over 90,000, accounting for 97 percent of Polish transport enterprises (*Gregorczyk et al.* 1995).

This extremely liberalised market regime does not, however, comply with the standards of the EU given that the latter require the observance of minimal social and safety standards for the drivers and of technical norms for the vehicles. As early as 1992, under pressure from Poland's Western EU neighbour, Germany—the country worst affected by the unregulated traffic—the extreme liberalisation in the field of international transport had to be reversed (Rydzkowski and Wojewodzka-Krol 1995). Consequently, the Polish government passed new legislation to tighten up the conditions for Polish transport companies seeking to enter the market for international transport. With further amendments to this legislation, increasing compatibility with currently valid EU norms is assured.

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[7]The following analysis will be focused on the road haulage industry. The impact of liberalisation and adaptation towards the European Union has been the fastest in this transport segment. There are strong reasons to assume that the features of the new road haulage system point to a more general trend in the Polish transport system. The recent legislation concerning the privatisation of the Polish Rail, as well as the organisational separation of its infrastructure and transport activity are paving the way for an increasing engagement of powerful foreign actors in the most lucrative market segments, and the systematic preference for investments in cross border traffic (PGT 10. 20. 1999, p. 2; 10. 27, p. 2).

Furthermore, the modal focus chosen in this analyses reflects the growing importance of road transport within the Polish transport system: Between 1990–1997 the ton-km performance of the road haulage industry almost doubled. In contrast, railway transport, measured as a share of GDP at PPP, declined by more than 40 percent over the same period (*World Development Report 1999–2000*, p. 265). The shift towards an automobile-centred transport system shows that one distinct characteristic of the state socialist heritage, namely the extreme dominance of railway transport, is rapidly being deconstructed.

However, so far Poland has not managed to fulfil another important criterion for its accession to the Union: the re-regulation of its domestic transport, which is clearly at odds with EU requirements. A recent document presenting the opinion of the European Commission on Poland's application for membership claims: "The road haulage sector complies with most of the provisions of the *acquis* relating to international traffic but the operation of its domestic arm poses greater potential risks. This aspect will require close attention and is of particular importance in the context of a future Union without internal borders when road haulage cabotage will be totally unrestricted. If it is to be in a position to enter the Union's internal transport market, Poland will have to make an early start on putting its domestic haulage in order both as regards market access conditions and compliance with the safety and social rules" (*European Commission* 1997, p. 83).[8]

Why has Poland not "put its domestic haulage in order"? I can only speculate about the reasons. It seems clear that a re-regulation of the domestic market would immediately devaluate the technical infrastructure inherited from the former system. Many of the trucks and trailers used on the domestic market are technically obsolete, but most of the new private enterprises do not have the financial means to modernise their equipment and they would be crushed out of existence by the new, stricter regulations. Yet, even if the small enterprise sector might not be sustainable in its recent shape in the long run, for a transition period it may function as a "subsistence economy", allowing for the survival of a workforce which has become more or less obsolete in the course of economic reforms and would otherwise be threatened by exclusion.[9] Thus I suspect that the real motivation for the extreme liberalism of the Polish policy-makers towards the domestic transport regime is probably their wish to maintain *a substitute social welfare arrangement*.

There is another field where the "Europeanization" of Polish transport has been Janus-faced at best: it is the transport infrastructure. It is well-known that, just like in other state-socialist countries, transport, and, specifically, road transport was not considered a branch which had priority with respect to investment. As a consequence, even if Poland has inherited a relatively dense network of roads, and

[8] In 1997 and 1998, two new pieces of legislation concerning international and domestic road transport came into force. Both make important contributions towards tightening the conditions for market access, and thus aligning Polish legislation more closely to that of the EU. However, the law on domestic transport covers only passenger transport. Thus, the liberalised market regime for domestic road haulage still prevails (*Swiatecki* 1997, *Burnewicz and Bak* 1999, p. 26).

[9] The same argument holds even more true for the situation in the agricultural sector, where no significant steps towards modernisation and rationalisation of the extremely small average size of farms have been initiated so far, although the Polish agricultural sector is considered to be a major obstacle to accession to the EU. Whereas the delaying of reforms allows for the peasants' survival on the *margin* of the economy, a sudden change in the situation—in the absence of a compensatory and welfare system prepared for the integration of additional millions—would lead to the social and economic *exclusion* of these people.

a high density railway network, their standards are extremely low compared to those in the European Union (*Bennathan and Thompson* 1992; Gregorczyk et al. 1995). Of particular concern for both the EU and Poland is the missing motorway network; this is a particularly big problem given that one of the results of the West-orientation of the Polish economy includes the increasing importance of the road transport, and the decline of railway transport within the whole system.

In 1994, when the Conference of European Transport Ministries decided about the extension of the TEN-programme to the East European countries, the Polish government committed itself to the giving of priority treatment to the development and modernisation of "pan European" motorway links (*MTGM* 1995). Four of the links which are considered priority "pan-European corridors" cross Polish territory: the Via Baltica, linking the Baltic states with Poland, two east-west axes, one linking Berlin with Moscow via Poznan and Warsaw, and one linking Berlin/Dresden with Kiev, via Silesia and Krakow, and finally a north/south axis linking Gdansk with the Czech Republic (*Anderson* 1997; *Suchorzewski* 1997). The realisation of the development and modernisation of these corridors faces serious difficulties, however. The Polish government planned to invest about ECU 5 billion of its own budget over the period 1995–1999 in road infrastructure, taking into account its future inclusion in the TEN. This rather ambitious sum amounted to about 1.2 percent of annual GDP, and would have required a radical turnabout of the negative trends evident since 1990: in that year the share of transport investment in the GDP stood at 1.1 percent, while in 1994 it was only 0.5 percent (MTGM 1997). This turnabout, however, has not occurred. While some construction has been carried out with the financial participation of the state, the PHARE-programme, EIB and EBRD, recently the GDP-share of infrastructural investment has continued to be as low as 0.5 percent (*Jastrzebska* 1999). Furthermore, even if the planned 5 billion had been available, it would have been a long way from covering the whole cost of motorway construction, estimated at about 10 billion ECU (MTGM 1997, p. 21). This was clear from the beginning and in order to attract private investors the Polish government adopted a far-reaching piece of legislation: the Act of 27 October 1994 on toll motorways. Under this financing arrangement the government issued concessions to private companies for the construction and operation of motorways, or segments of motorways, for a specific period of time. Yet this concession programme has not brought about a breakthrough. By 1999 concessions had been issued for five segments only—A1, Gdansk-Torun (152 km), A2, Swiecko-Poznan, Poznan-Konin, Konin-Stryków (362 km) and A4, Katowice-Kraków (61 km)—covering altogether 539 out of the 2600 km planned; not surprisingly, these were segments which were expected to yield high profits. Clearly, the feasibility of such motorway programmes depends on the ability to produce sufficient toll revenues to recoup the investment. So far Eastern Europe's experiences with this type of financing are neither numerous, nor promising.[10] Observers in Poland note that the tolls required are extremely high in relation to income.

In order to improve the results, under the current government new legislation is being prepared; this will allow the state to take greater political and financial responsibility for the development of the infrastructure. In addition, better mobilisation of the EU pre-accession funds will be brought about in order to support the realisation of the Motorway Construction Programme (Jastrzebska, 1999). While it would be too early to evaluate the new plans, based on the past experience it seems quite probable that instead of a comprehensive motorway system, Poland will construct a "patchwork" system of partly modernised and partly obsolete pieces of motorways coexisting next to each other. Another result of the priority treatment of international traffic axes will possibly be the degradation of the regional and local network. This option is already clearly adopted in the rail network programme, where the modernisation of international links is to be realised at the expense of the existing network. 6000 kilometres of existing rail links are to be eliminated (MTGM 1995, *Institute for Sustainable Development* 1996). In this way, Poland's "Return to Europe" will be only partial in a territorial sense as well.

The two fields discussed above reveal a fundamental problem. On the one hand, Polish transport policy respects the requirements of compliance with the Western European system as an important political goal; thus it accepts that an already existing international order shapes the restructuring of the national transport system. On the other hand, Poland does not enjoy the same institutional support as do the member states of the European Union. Whereas the former are at least partially compensated for the costs of adaptation, Poland, as a nonmember, has to rely to a much larger degree on her own resources. Given that massive infrastructural investment goes beyond the capacities of the Polish state, Poland adopted a selective approach, working in favour of the needs of cross-border transport and neglecting the restructuring of the domestic transport system.

Thus, a *fragmented transport regime* has emerged: while the domestic transport market is characterised by an almost complete absence of regulation and of formal institutions, by a large number of small firms operating under highly precarious conditions, and by a more and more obsolete and low-standard infrastructure, the cross-border transport segment is embedded in the framework of existing western European regulation. Thus it has undertaken at least the "patchwork-modernisation" of its infrastructure. Regularised market features, however, concern only a minor segment of the transport market. Out of over 90,000 transport enterprises, only about 6,000 operate on the international haulage market. Therefore, this is not yet the end of the story. If Poland wants to enter the EU, it has—among

[10] In Hungary the results of the first tolled motorway, linking Budapest with Vienna and Bratislava, experienced an 18 percent fall in traffic between 1995 and 1996, compared to an expected 6 percent growth (*Judge* 1997, p. 348).

many other tasks—to re-regulate its domestic transport market. Re-regulation is a precondition for fully opening up the Polish domestic market to foreign enterprises, and for Polish enterprises being allowed to operate throughout Europe thus exposing Polish enterprises fully to European competition.

In the remaining section of my article I will analyse how far the historical heritage, the new transport regime, and the international opening of Polish transport markets affect the capacity of Polish enterprises to cope with the growing competitive pressure.

From path dependency to dependency? Enterprise strategies and the polarisation of the Polish transport market[11]

The organisation of the Polish road-haulage industry up to the late 1980s reflects the economic system of central planning. Freight transport was performed by a small number of large, integrated combines operating under the auspices of either the transport ministry or the ministries responsible for individual sectors. Not unlike the situation with a fordist transport regime, the division of labour between the various companies was based on delineating and regulating individual markets. A clear demarcation was drawn between the areas of responsibility of the various corporate groups (especially with respect to national and international transport), and forwarding and transport activities. Another feature of the Polish road-haulage industry was the high share of own-account transport operated by industrial and trading companies. Hedging against the risks of transport constraints in cases of unplanned changes in production or trade, firms developed their own transport capacities. Again, it is worthwhile stressing the similarity between the fordist and state-socialist (road) transport systems. Own-account transport, which, due to the heavy constraint of regulation, could not operate very productively, nevertheless accounted for up to half of the market in Western European countries as well, reflecting the large and integrated fordist firms. It was only after the rationalising potential in the distribution process had been discovered that own-account transport decreased (Plehwe 1999).

The transport market as a whole matched by a low degree of differentiation. The demands made by shippers usually related merely to simple goods transports from one location to another. Forwarding firms were primarily responsible for organising the switches between means of transport. A demand for more far-reaching integration of transport and forwarding services, or a more highly differentiated range of services by transport companies, hardly existed. As a result, from a not

[11] The following is based on the results of a research project on the transformation of Polish transport enterprises conducted at the Wissenschaftszentrum Berlin in 1996/97. For a more thorough discussion of the results cf. Bohle (1997).

dissimilar starting point, from the mid-1970s/early 1980s onwards a considerable modernisation gap emerged between the (road) transport systems in the West and the East. Whereas the former underwent major changes, the systems in the East still reflected the features of a highly regulated, nationally organised and increasingly technically backward system.

How then has the new market regime which has been implemented since 1988 affected the modernisation gap? Contrary to what the Polish reform elites intended, the modernisation gap could not be closed by means of radical market reforms. The Polish commitment to radical liberalisation which aims to promote the emergence of a new private sector and enhance competitive relations—has in fact undermined the sustainable development of enterprises.

The new private sector established under these conditions is characterised by highly fragmented corporate units, a weak capital base and high fluctuation. Cut-throat price competition has resulted between the various, mostly very small, companies. The competition is exacerbated by the fact that freight charges have been completely liberalised. Prices are negotiated in bilateral agreements between the shipper and the transport company. Frequently, the calculation of domestic freight charges is based on variable costs alone. Many companies are—in the literal sense—driving their vehicles into the ground. Once the last truck finally grinds to a halt, the company folds. Ironically, the mechanisms that decide the future of each individual enterprise are in accordance with "textbook" descriptions of the way markets work. The market decisions taken decentrally by mutually independent enterprises are coordinated solely via price. Contrary to textbook assumptions, however, this variant of market coordination apparently represents the central weakness of the sector. The predominance of pure price competition leads to dumping with respect to services and standards, blocks the endogenous growth of firms and destroys any seeds of cooperation. In the organisational dimension the above situation also implies that, so far, firms have failed to bundle their common interests and seek better operation conditions. It is with good reason that the Polish transport journal (PGT) described the freight carriers serving the domestic market as the "forgotten caste" of Polish politics (*PGT* 6. 12. 1996; 1. 29. 1997).

If the new private sector has so far not developed major competitive strength, then how about the (former) state-owned enterprises (SOEs)? Without being fully privatised, so far most of these companies have undergone a property transformation and they exhibit variations of hybrid property, where privatised parts of the firm remain tied to a state parent company through lease contracts. Only very few of the state-owned enterprises have been taken over by foreign owners. The former SOEs have also suffered from their being embedded in an ultra-competitive environment. However, because they are long-standing actors on the market, a number of them can draw on inherited resources in order to survive. By concentrating on established market segments, these enterprises have been partially successful in avoiding competition. However, in most cases, this is a precarious and short-sighted strategy. A decisive move towards more complex transport and logistic operations has been notably absent from the restructuring path of former SOEs. With the exception of only a few enterprises, instead they pursue a gradual restructuring process, oriented towards inherited organisational limits, activity profiles and customer relations—very much in line with the perceptions of the path-dependency analysis.

This gradual restructuring path is further illustrated by the fact that the role of own-account transport is still very important. Although its share has systematically diminished since the beginning of the 1990s, this mode of transport still dominates in goods transport (*GUS* 1997). Unlike emerging trends in the West, where transport and distribution are increasingly being outsourced to one single enterprise, outsourcing in the Polish case would mean giving away the control over logistics to western enterprises, given that there are only very few Polish enterprises that offer integrated logistic services.

The analysis so far seems to confirm path-dependency approaches both with regards their criticisms of neoliberal reforms and their emphasis on the role of institutional and organisational legacies in shaping the transformation. On the one hand, rapid liberalisation and marketisation of the Polish domestic transport market *has not led to the emergence of competitive enterprise structures*. On the other hand, wherever it has been possible, enterprises have used *inherited organisational and institutional structures as resources* for current strategies. The main question remains, however, how sustainable these features are in the long run when they are confronted with an increasingly internationalised environment.

To answer this question I will draw some conclusions from the development of *cross-border transport*, where Polish enterprises quickly confronted the requirements of Western firms; the latter playing an important role in organising Polish foreign trade.[12] The gap existing between the needs of foreign enterprises for logistic services and the level of transport services offered by most Polish firms is filled by Western forwarding and logistic enterprises. Out of 31 of the largest Western transport and logistic enterprises 22 are present on the Polish market (*Dörrenbächer and Schmitt* 1997). Their investments are concentrated in the segments of forwarding and warehousing. They are introducing new technologies on the Polish market, such as satellites and telecommunication, as well as new techniques of market monitoring. Not surprisingly, these corporations tend to geographically concentrate their investment on the most developed cities and regions. Out of 86 offices and branches of western transport and forwarding enterprises in Poland registered by

[12] According to the Handelsblatt, foreign investors control about half of Polish exports (*Handelsblatt 2.* 6. 1999). To this share we have to add Western firms that do not invest directly in Poland but include the Polish area in their sales markets, and those that organise the outward processing traffic (OPT) arrangements. OPT-based exports accounted for 23 percent of Polish exports in 1995 (*Kurz and Wittke* 1998).

Dörrenbächer and Schmitt (1997), 52 are concentrated in five areas—namely, Warsaw, Gdansk/Gdynia/Sopot, Poznan, Szczecin and Katowice; only 9 are located in the eastern part of Poland. Thus the network of western enterprises mainly links some selected poles of growth in western Poland with the West. Furthermore, the transport enterprises themselves play some role in reinforcing the process by which there is greater regional heterogeneity. One of our interview partners reported that he, having knowledge of the geographical, infrastructural and administrative patterns of Poland, advises his clients where to invest.

Most Western firms do not possess their own means of transport—rather, they engage Polish freight carriers as subcontractors. According to estimations of the German transport review, around 70 percent of cross-border transport between Poland and Germany is operated by Polish freight carriers, and only around 25 percent by German carriers. In the case of Dutch-Polish transport, around 60–65 percent is operated by Polish, and roughly 30 percent by Dutch carriers (DVZ 5. 31. 1994, p. 22; and 12. 3. 1994, p. 12). In formal terms, these firms are independent and responsible for maintaining their vehicles and for social security. However, they often have exclusive contracts—that is, they are not allowed to work for other firms, but are heavily dependent on the foreign forwarding firm. The Western companies benefit from the wage differentials which exist between East and West. Freight can be brought to the Western countries under Polish wage conditions and on the return journey freight can be brought back to Poland. This is a mechanism to at least partially circumvent the ban on "cabotage" (i.e. the regulation forbidding firms from third countries to operate on the domestic markets of the EU countries). Furthermore, aggressive competition practices on the part of Western enterprises seem to be growing in significance. Backed by their head offices, the latter are able to offer dumping prices in order to enter the Polish market, thus putting even those Polish firms which might be able to compete under significant pressure (MTGM 1997).

It is against this background that the possibility for Polish firms to benefit from the growing importance of Western integration has to be evaluated. A substantial number of the 6,000 Polish enterprises in international transport presumably only represent *the bottom end* of a logistic chain organised by Western enterprises. Yet, completing the picture, there are exceptions, some of which would even confirm the views of these path dependency theorists on the relationship between the legacy and competitiveness. One of the most successful Polish enterprises in cross-border transport is the former state monopoly for international transport. This group was able to draw on its former privileged position in restructuring and to successfully expand its activities. It is increasingly turning into a modern, multimodal transport concern. Other examples are the former foreign trade monopolies, which are still important Polish players in foreign trade and provide their transport in-house. It will be interesting to see whether these groups will survive as Polish groups. In other Eastern European countries, such as Hungary and Bulgaria, the former state monopolies for international transport were taken over by foreign owners. The chances for future take-overs in Poland are underlined by the fact that even the biggest national firms are small compared to their Western rivals.

A further demonstration of the influence of Western firms on the reshaping of the Polish transport market is provided by the emergent market segment of *courier, express and package services* (CEP market). This business involves door-to-door transport, largely of packages of up to 30 kg. The companies take on responsibility for collecting, transporting (overland, by sea or by air), customs formalities (where appropriate) and delivery, worldwide and at guaranteed times and prices (*Aberle* 1996, pp. 479f.). By far the greatest share—almost 90 percent of this market segment—is in the hands of just a few companies, the so-called "integrators", DHL, UPS, FedEx and TNT. Plehwe (1994) underlines the fact that the integrators have played a significant role in restructuring the Western transport systems. In the US and Western Europe they played a pioneering role in reorganising transport and forwarding firms by setting new benchmarks with respect to the frequency of deliveries, delivery follow-up, corporate structure and their industrial mode of operation.

On top of this the integrators have been important actors in the process of deregulating transport markets worldwide. For example, the deregulation of air traffic in the USA was due so significantly to the activities of FedEx that the corresponding law of 1977 is termed the "Fed Ex Law" (*Hamilton* 1990). Plehwe (1994) describes how the express services have played the role of "Trojan horses" in the worldwide deregulation of transport markets by picking—not always in accordance with the prevailing regulatory stipulations—the cherries out of heavily regulated national post and transport markets. In order to avoid being under persistent legal attack from competitors, the international courier services formed branch associations together with local express and package services and made decisive efforts to bring about the liberalisation of these markets at both national and international level.[13]

Since the 1990s a similar process is to be observed in Poland and other CEE countries. Currently DHL has 19, TNT 14, UPS two and FedEx one subsidiary office in Poland (Dörrenbächer and Schmitt 1997). Another important player on the Polish CEP market is the German postal service. The increasingly "multinational" Deutsche Post acquired a majority share in the second largest Polish package operator, Servisco, which at the same time is the major competitor of the Polish postal service in this market segment (*Handelsblatt 6*. 25 1998, p. 55; *Nachrichten für den Aussenhandel* 3. 31. 1994, p. 6). While the expansion of the integrators was initially

[13] Interestingly enough, the same postal operators who were targeted by the strategies of the integrators later started to strike back. Two of the integrators are now operating under the control of, or in strategic alliances with European postal operators: the Dutch postal service KPN took over TNT, while the German postal service acquired a share in DHL (Plehwe 1999).

linked to the operations of multinational companies in Poland and served primarily international logistical relations there is a growing interest in the domestic market as well as the example of the Deutsche Post shows. This is also clear from the fact that using the strategy they tried in Western Europe, the integrators, together with only one (!) Polish enterprise, founded a trade association in 1996, which now has ten members. Since the foundation of this trade association attempts have been made to undermine the remaining privileges of the Polish postal service in the CEP market.

Thus, under the dominance of foreign enterprises an important market segment is being reorganised. The influence of existing structures and institutional arrangements—e.g. the national postal system, or the semi-privatised national transport companies—is being undermined, with the most lucrative markets falling under the control of private enterprise from the West. While Polish firms are not excluded from these segments, they are constrained by their comparatively small size and limited technological and infrastructure resources; thus they remain at best "junior partners" of the multinationals, serving domestic and regional market niches (PGT 20. 3. 1996, p. 1; PGT 5. 2. 1997, p. 8; *The Warsaw Voice* 20. 6. 1999).

5. Summary and conclusions

This study has attempted to interpret the restructuring of the Polish transport industry on the basis of an elaboration of the relationship between the international and the path-dependent dimension.

First I demonstrated that a transnational integrated European economy is emerging, in which national policies of deregulation are combined with the growing role of supranational institutions, and new global market actors and new forms of market hierarchies are emerging. I argued that Polish political actors have explicitly linked their policies to the aim of European integration; thus they have accepted that an already existing institutional order is to shape the direction of restructuring of the national transport system.

Second I showed that because Poland has not been capable of deploying the necessary resources for a successful adaptation, a selective approach has been adopted. This has worked in favour of the needs of international transport while neglecting the restructuring of the domestic transport system. Thus a fragmented and dualistic transport regime has emerged in terms of its institutions and regulations, its geographical patterns, and its infrastructural development.

Third, I made clear, this fragmented regime has resulted in strikingly different firm structures and business and organisational strategies. Thus, ultimately, it works in favour of those multinational forwarding and logistic enterprises occupying strategic market segments in Poland, whereas the endogenous transport enterprises are in danger of being marginalised.

Despite the fact that the cross-border market segment is still a marginal part of the Polish transport market, I have taken the risk of presenting a more general hypothesis about the future Polish trajectory in a unified Europe. Two facts—namely, that its regulation adheres most closely to the standards of the EU, and that the most direct confrontation with Western competitors has already occurred in this market segment—suggest that similar restructuring processes may easily evolve in other sectors of the Polish economy as well. Specifically, unfavourable legacies combined with radical internationalisation, and the lack of institutions supporting competitive restructuring, may make other sectors fragmented and dualistic. These developments could deprive Polish enterprises of the chance to become competitive with their Western rivals on the most lucrative market segments. Thus they will be junior partners, either to be found at the bottom end of the value production chain organised by Western enterprises, or dissociated from the modernisation process altogether.

Thus we cannot exclude the chance that a future "European" Poland indeed will have a few European sectors characterised by European regulation, technology, organisation, business strategies and infrastructure; however, the major actors, who design and enforce the rules, and capture the gains in these "islands of modernisation" will be literally Europeans: the global European corporations, and the transnational EU institutions. If this does turn out to be the case, Poland's development performance will be shaped and constrained by the proportions, and relationship between the "Europeanised" parts, and the rest of her political economy, and society.

My findings challenge one of the basic transformation-theoretical arguments of institutionalist approaches. Their advocates have argued that the neoliberal blueprints designed by international advisors for the transition countries have failed to grasp the reality of the reform processes because they ignored the role of institutional legacies, (i.e. the main resources of actors in the transformation process). Consequently, they have turned to the analysis of institutional legacy, and have tried to identify the inherited "assets". These "origin-driven approaches" (*Burawoy* 1994) tend, however, to neglect the fact that perhaps it is not so much the abstract neoliberal master plans but the concrete European neoliberal polity, and the incorporated power relations, which have become the crucial factors shaping and constraining the trajectories and perspectives of transformation. *The global and European neoliberal capitalist order sets the standards against which any path-dependent performance, and "third-way" experiment is measured.* One might argue, therefore, that global neoliberalism indeed incorporates a blueprint for the East European trajectories. The future of the East European countries is, most probably, not represented by Western Europe or North America, but by Mexico or other peripheral regions.

The dual features of Poland's current transport system are reminiscent of older experiences with peripheral capitalisms. There are reasons, however, to believe that the current process of fragmentation and dualisation goes much further than the analogy to dependent capitalism suggests. Due to the institutionally secured, market-led integration within the EU, the dualism of transnational integration and domestic fragmentation is tending to become a universal development feature throughout Europe, although affecting core and peripheral societies in an uneven way. The novelty of *emerging peripheral capitalisms, which are part of an ongoing process of European state formation*, has yet to be explored.

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RESTRUCTURING AND PRIVATISATION OF THE BULGARIAN BANKING SECTOR

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This article is a brief review of developments in the banking sector in Bulgaria as well as an analysis of the political and macroeconomic factors that have influenced this process.

It begins with a historical overview of the different stages in the evolution of the Bulgarian financial sector. Greatest attention is placed on banking sector reforms after the abandonment of the "monobank" system. In particular, the bank consolidation process, the "bad debt" problem, and the 1996 banking crisis that occurred during the transition period are discussed in detail. These developments are properly linked to the relevant macroeconomic factors and legal framework as well. Furthermore, the recently achieved stability in the banking sector is justly ascribed to the introduction of the currency board in 1997. The stabilizing effects of the currency board are highlighted.

Finally, a brief overview is included of both the political and economic stabilization in Bulgaria up until the end of 1999 and it provides the necessary background for understanding the achieved progress in bank privatization over the last two years. In fact, at the end of 1999 approximately half of the total bank assets were in private hands.

Historical overview of developments in the Bulgarian banking sector (1879–1944)[1]

The foundations of the banking sector in Bulgaria were laid shortly after Bulgaria's liberation from Turkish domination, in 1879, when the Bulgarian National Bank (BNB) was established as an independent credit institution. Its Act of Incorporation defines its role as a facilitator of the revival and development of trade relations in the country as well as a regulator of domestic credit and economic activity. In 1885, the BNB was also granted emission functions. (Avramov, Petrov and Ianovski 1999, p. 13) Moreover, up until 1906 the BNB remained the only deposit-credit institution that provided general credit of country-wide significance. Its resources were of the utmost importance for providing credits to both the private sector and the existing agricultural funds. (BNB 1929, p. 99)

In addition, numerous small provincial banks appeared in the post-liberation period. However, they operated more like savings associations rather than commercial banks because of the lack of savings and active trade and industrial activity. These institutions participated only in the grain production trade on a commission basis or in direct partnerships. (Op. cit., p. 98) Generally, the main activity of the savings associations was to provide credit to trade activities and, later on, to fledgling industries.

[1] Information comes from *Avramov, Petrov and Ianovski* 1999 and *BNB* 1929.

At the same time, special agricultural funds existed which financed only agricultural activities. Their capital consisted of private investments. After 1889 the agricultural funds were allowed to collect deposits as well.

Later on, in 1904, all agricultural funds merged into a single financial institution, the Bulgarian Bank for Agriculture (BBA). This developed as the main source of long-term and short-term credits for agricultural activities.

Along with the BNB and the BBA, a third financial institution was established in 1911: the Bulgarian Central Cooperative Bank. Its main functions were to provide loans to cooperatives as well as to provide insurance against crises.

However, as mentioned above, prior to 1906, the BNB was the most significant among credit institutions because of the unfavourable economic environment for private banks. It is worth noting though, that the BNB undertook effective measures to stimulate the deposit raising rate of private banks. For example, in 1902 the BNB decreased its interests on savings deposits, thus reorienting savings flows to private banks. Moreover, up until 1912 the BNB actively started crediting private banks through discounting operations as well as by opening special current accounts with the private banks. (Op. cit., p. 100)

From 1906, however, Bulgaria began to experience economic boom and new, equally powerful financial institutions started operations in the country. The political and economic stability which was achieved attracted foreign capital as well. As a result, at the beginning of 1906, three large foreign banks opened branches in Sofia. (Op. cit., p. 99)

By the beginning of the 20th century, economic activity had developed substantially and private savings increased and started entering the banking sector. This led to greater financial activity on the part of private banks in the country. Thus, between 1906 and 1912, 31 new banks were established while the total number of these institutions reached 67 by the end of 1912. (Ibid.)

A crucial point in the development of the Bulgarian banking system was the Balkan war of 1912. It caused great distortions in the country's finances. Due to the increase of the monetized state debt as well as the depletion of the BNB's reserves, the Bulgarian lev (BGL) depreciated substantially and high inflation was triggered off. (Avramov, Petrov and Ianovski 1999, p. 78)

Therefore, in 1913, the BNB set up a Foreign Exchange Syndicate in agreement with the largest private banks in order to protect the BGL from further depreciation. The syndicate used the reserves of both the participating private banks and the BNB to satisfy the increased demand of foreign currency. As a result, the BGL regained a substantial part of its value. (Op. cit., p. 79)

However, the BNB's relations with private banks and its crediting activities were significantly undermined in 1915 when the Ministry of Finance overtook the emission functions and reserves management of the BNB. Subsequently, government debt and banknote emission increased sharply causing another BGL depreciation and more inflation.

Surprisingly, between 1916 and 1919, the increased inflation enabled the accumulation of free capital and this was used for the establishment of new private banks. This tendency prevailed long after the Balkan war, and despite the great domestic currency depreciation, new banks constantly emerged in the period 1913–1927. Thus, in 1927, private banks totalled 140, seven of which were foreign-owned. However, the banking system as a whole was highly dispersed with a prevalence of small provincial banks. (BNB 1929, p. 100)

It was only after the economic stabilization of 1923 that the BNB regained its regulatory and stabilizing functions. In 1924, the BNB was granted total control over foreign exchange operations in the country. It managed the entire trade with foreign payments instruments and it determined the exchange rates. As a result, its reserves increased and the BGL exchange rate was stabilized to its market level. Along with that, the BNB resumed its financing to the private banks through discount operations and special current accounts (at end of 1929, 42 percent of the BNB's assets represented credits to private banks). (Op. cit., p. 104)

In addition to that, amendments to the current Law on the BNB strengthened its autonomy, eliminated its direct credits to the government, and required that its banknote emission have adequate gold coverage. Furthermore, the 1929 Law on BGL Stabilization annulled the BNB's monopoly on trade with foreign payments instruments.

These last positive trends at the end of the 1920s created auspicious conditions for a further successful development of the Bulgarian banking system. Moreover, from 1926 these developments were accompanied by a clear tendency towards bank mergers and concentration of the banking system. Bulgaria was on the road towards establishing a well-functioning banking system.

Unfortunately, this process was interrupted in the early 1990s when world economic crisis affected the Bulgarian economy as well. Then the BNB started crediting the budget deficits again as well emitting inflationary money. The financial discipline was eroded once again after the Balkan war. The situation worsened when Bulgaria entered World War II. After the war the country's economy was completely decapitalized because of the extremely high inflation.

The following stage in the development of the Bulgarian banking system was the so-called "monobank period" when the state gained monopoly over all banking activities in the country after nationalizing the existing private banks. The BNB merged its emission and crediting functions and it was given full control over the balance-of-payments of the country. The monobank period started in 1947 and lasted for 43 years.

The post-"monobank" period (1997–to the present)

After the collapse of the centrally planned economy Bulgaria adopted a two-tier banking and monetary system. The new statutory law of 1991 granted the BNB the classical functions of a modern central bank. Along with that, fifty-nine branches of the BNB were hived off and transformed into joint stock companies. The legal framework which was introduced allowed free entry and unchecked banking operations. As a result, by early 1991, there were 69 commercial banks—established as joint-stock companies—along with the three existing ones.

The appearance of such a large number of banks posed substantial risks for the financial sector, considering the lack of proper bank supervision and regulations. Moreover, there were no qualified and experienced professionals to manage the banks in the new economic situation. Individuals with the particular culture and knowledge of banking acquired under socialism had to perform functions completely alien to them.

As a result, credit allocation continued according to old habits. Thus, the banks were quickly weakened financially, incurring bad loan portfolios and substantial decapitalization.

Bank consolidation

The large number of state-owned banks and their financial weakening caused serious problems to the regulatory authorities. In order to bring some order to the banking sector, the Bank Consolidation Company (BCC) was established as a share-holding company in 1992. With Ordinance No. 26/March 1992, the Council of Ministers ordered all shares of commercial state banks in possession of state-owned enterprises and other state institutions to be transferred to the BCC.

In the initial period of its establishment, the BCC's priority was to reduce the total number of state-owned banks through mergers or acquisitions on a voluntary basis. The first consolidation project of the BCC was concluded in the second half of 1992. The BCC encouraged a merger between Doverie Commercial Bank, Stroybank and 20 other small banks. As a result, the United Bulgarian Bank (UBB) was established at the end of 1992. (*Jotev* 1998, p. 2)

The consolidation process continued in 1993 when the BCC helped the creation of Expressbank by a merger of 12 state banks, and also with the establishment of Hebrosbank by a merger of another 8 state banks. In both projects, however, a mixture of administrative and economic measures were applied by the BCC in order to enforce the mergers. (*OECD* 1997a, p. 130) It was in 1994 that the BCC encouraged the voluntary merger of Hemus Commercial Bank, Sofia Commercial Bank, Elektronika Commercial Bank and Kazanluk Commercial Bank to create

Sofiabank. A year later, Sofiabank merged with Bank Biochim and several smaller banks and this gave birth to Biochim Bank. Biochim Bank was the last consolidated bank to be established.

The state authorities expected the bank mergers to result in stronger banks. However, the consolidation process did not improve the financial position of state-owned banks since the banks were weak and their merger led to bigger but equally weak banks. The real problems of the banking sector, such as low capital base and inefficient management, were not addressed.

The settlement of bad loans

As early as 1991, the Bulgarian government chose the easy but least effective way of "nationalizing" 25 percent of the non-performing bad loans extended before 1990 without initiating any structural reforms in the banking sector. The estimated proportion of bad loans taken over by the state at that time was about 7 percent of GDP. A similar proportion of bad loans was also written-off by the government in 1992–1993. (OECD 1997a, p. 102)

Thus, the financial discipline in both the banking and the real sector was eroded. Practically, all state-owned enterprises stopped servicing their old bad credits while banks continued imprudent lending. By the end of 1993, the Bulgarian banking system was experiencing substantial losses. (Op. cit., p. 123)

In order to recapitalize the ailing banking institutions, in December 1992 the Parliament passed the so-called ZUNK law (the name given after the Bulgarian acronym). Under this law, the state assumed responsibility for all non-performing bank loans issued before 1991, placing bonds of equivalent value in the portfolios of affected banks. The nominal value of these bonds was approximately 35 percent of GDP. (*Bulgaria's...* 1998, p. 5)

However, the ZUNK law did not provide a viable solution for the financial problems of the banks. It addressed only the stock aspect of the bad loan problem and completely disregarded the existing flow problem.

The lower than market average return of the ZUNK bonds exacerbated the liquidity difficulties of the banks. The latter had to pay higher interest rates on their liabilities than those earned on the ZUNK bonds. In order to cope with this problem, the bank managers resorted to methods that worsened the financial difficulties: e.g. higher spreads, higher deposit rates and increased expensive BNB refinancing.

Moreover, the unconditional bank bailout under the ZUNK law did not enforce any changes in the imprudent lending practices of banks. Extensive risky and insider lending continued. New bad loans quickly accumulated (see *Table 1*).

Table 1

Development of the portfolio of the Bulgarian banking sector

	1994	1995	1996	1997	1998
Total assets of the banking sector (BGL mn)	860,892	1,087,000	3,631,000	7,410,000	7,685,000
Bad and doubtful loans (percent of total assets)	6.8	12.6	14.6	12.9	16.1

Source: BNB, EBRD, IMF

All these negative trends in the banking sector, along with the continuing recession in the real sector and the lack of restructuring of the state-owned enterprises led to the banking crisis of 1996.

The banking crisis of 1996

The banking crisis was induced by both economic and political factors. First of all, the overall performance of the economy was gloomy. The gross domestic product for 1996 decreased by 10.9 percent (see *Table 2*). This was mainly due to a fall in state industrial and agricultural output. In 1996 state-owned industrial production decreased by 3.3 percent in real terms in comparison to that of 1995. (*EIU* 1997a, p. 21) However, total industrial output fell by only 1.1 percent because of the dynamism of the private sector.

Table 2

Macroeconomic indicators for Bulgaria (1991–1997)

	1991	1992	1993	1994	1995	1996	1997
GDP at constant prices (percent change)	11.7	7.3	1.5	0.8	0.1	10.9	6.9
Industrial gross output (percent change)	21.0	6.4	6.2	0.0	5.4	8.3	7.0
Agricultural gross output (percent change)	0.3	14.8	30.2	0.5	4.5	18.1	0.0

Source: EBRD Transition Report 1998

The lack of structural reforms and privatization initiatives by the socialist government in power in 1996 was the main reason for the poor Bulgarian economic performance. The general practice in the country was that private firms—mainly in retailing and services and close to the government—thrived on parasitic relations with state-owned enterprises. Thus, the state enterprises were asset-stripped and experienced substantial financial losses. Most of them stopped servicing their bank loans.

At the same time, the government put political pressure on commercial banks and encouraged them to finance enterprise losses by issuing new non-performing loans. (Bulgaria's... 1998, p. 4) By the end of 1995, the standard loans extended by commercial banks were only 25.9 percent of all loans in the consolidated bank balance sheet. (*BNB* 1995)

In addition to this, the corrupt behaviour of bank managers increased insider lending. As a result, 25 percent of total bank assets were irretrievably lost in the form of bad loans to firms close to bank managers. Most interestingly, even the private banks did not distance themselves from the vicious practice of insider lending. At the end of 1995, the non-performing loans extended to private companies amounted to 5 percent of Bulgarian GDP. (OECD 1997a, p. 4)

All these factors resulted in a highly negative net worth of the banking system. By early 1996, the Bulgarian banks reported a negative equity of around USD 1.3 billion which equalled 13 percent of GDP. (Bulgaria's... 1998, p. 4)

These financial results of the Bulgarian banks aroused substantial public concern about the safety of people's deposits. There was a run on five banks and on the currency in general. The BNB's increase of the basic interest rate (reaching 108 percent in May) only slowed down the demand for dollars temporarily. (OECD 1997a, p. 114) Towards mid-1996 people started withdrawing their bank deposits on a massive scale. This caused a full-scale run on the whole banking system. By September 1996, the total deposits withdrawn amounted to USD 840 million at the spot exchange rate. (Op. cit., p. 105) The BNB had to take expedient measures in response to the banking crisis.

By the end of 1996, 16 commercial banks (state-owned as well as private) were placed under special supervision and bankruptcy procedures were initiated against several of them. (Ibid.) The banking crisis, as a whole, resulted in the closure of 19 banks accounting for over 30 percent of the assets of the banking sector. (Bulgaria's... 1998, p. 4)

Legal framework

The banking crisis of 1996–97 also instigated important amendments to banking legislation. These were all aimed at strengthening the banking system through stricter supervision and financial discipline.

The basic Law on Banks (which had been amended in 1996) was replaced by a new one in July 1997. As a result, the regulatory power of the BNB was considerably expanded. The new legislation granted the BNB the right to close a bank, and even obliging it to revoke a banking licence in a case of insolvency. The role of the court was limited to checking the legality of the documentation of the BNB. The decision of the BNB can no longer be contested by either the court or the bank in question. If the documentation is properly prepared, the court simply declares the bank insolvent or ready for liquidation. (*BNB* 1998)

Moreover, the new Law on Banks makes banks, as well as borrowers, liable and subject to legal prosecution for any inappropriate lending. (Op. cit., Ch. V)

From mid-1996 to early 1997, the BNB immediately exercised its new powers. It placed 16 banks in receivership and petitioned the courts for their bankruptcy. By early 1998, one merger took place while the 15 other banks were declared bankrupt. (OECD 1999a, p. 28) Prudential regulations were also strengthened in 1996 and 1997. The minimum capital requirement for the operation of a commercial bank was increased from BGL 2.2 billion to BGL 10 billion (DM 10 million) as of June 1998. In addition to that, minimum capital adequacy was increased from 8 percent to 10 percent in 1998. (BNB. Bank regulations) Along with that, the new Law on Banks obliges the BNB to withdraw the licence of any bank in default on payments for more than 7 days. (BNB 1998, Article 21(2)1)

Another important legislative change was the new deposit insurance system introduced in January 1998. It provided more limited guarantees such as 95 percent on deposits up to BGL 2 million, 85 percent on deposits between BGL 2 million and BGL 5 million and nothing above this level. (Op. cit., p. 15) The deposit insurance is funded from a 0.5 percent annual contribution paid by banks on all personal deposits. (OECD 1999, p. 29)

The introduction of the currency board in mid-1997 put an end to the BNB's refinancing (i.e. lending to troubled banks) as well. Moreover, the currency board played a leading role in stabilizing the financial sector as a whole. It was a part of a comprehensive reform programme initiated by the government of the United Democratic Forces (UDF).

The stabilization effect of the Currency Board on banks

Undoubtedly, "the currency board has been a crucial factor in the success of the country's stabilization program". (*Gulde* 1999, p. 1) It was introduced in July 1997 and provided the right conditions for the implementation of a successful stabilization programme: credible, rule-based exchange arrangements with legal and structural measures that addressed pressing banking sector and fiscal issues. The lev was fixed to the peg currency, the deutsche mark (1000 lev per 1 deutsche mark). On 1 January 1999, the fixed exchange rate to the deutsche mark was converted to the Euro on the basis of the official exchange rate of conversion of the deutsche mark to the Euro. The choice of the Euro as a peg currency was influenced by Bulgaria's political objective of EU accession and future integration into the Economic and Monetary Union. (*www.government.bg*. 1999) Under the rules of the currency board arrangement (CBA), the central bank cannot lend to the state or to any state agency, except against purchases of special drawing rights from the IMF. Furthermore, commercial banks can be financed by the central bank only if the stability of the financial system is endangered. (Avramov, Petrov and Ianovski 1999, p. 275) All these provisions have been conductive to the successful lowering of inflation and the elimination of the large-scale monetary financing of the budget. Thus imposed, discipline in the financial sector has been sustained by the prudent regulatory and supervisory activities of the central bank (which also acts as an official depository and fiscal agent of the Government).

As a consequence of the macroeconomic stabilization promoted by the introduction of the CB, the financial state of banks has improved substantially. The commercial banks are now well capitalized and their profitability has increased. (Op. cit., p. 32) This satisfactory performance of commercial banks under the CB is presented in *Table 3*.

Table 3

Financial indicators of Bulgarian commercial banks (percent)[a]

	1997	1998
Total capital adequacy	16.0	34.1
Return on assets	1.1	2.8

[a]Sources include BNB annual reports and estimates (*Yitzov et al.* 1998)

As a whole, the beneficial effects of the CB have restored people's trust in the banking sector and speeded up bank privatization. However, it is worth noting that these results were only possible because of the political will behind economic and democratic reforms. The political consensus reached in 1997 was crucial for the following transition progress and laid the basis of the current political stability in Bulgaria.

The political situation in Bulgaria in December 1999

As stated in the 1999 OECD economic survey on Bulgaria, "a general consensus among all major political fractions in Bulgaria in 1997 on the expediency of a currency board and comprehensive reform programme was an important accomplishment". (OECD 1999b, p. 20) Actually, this was a crucial point in Bulgaria's political life. It was then that a reform-minded government took power, supported by a strong parliamentary majority. Ever since, the government of the United Democratic Forces has successfully led the country through a transition period of political and economic reforms to the significant date of December 10, 1999 when Bulgaria received an official invitation for EU accession negotiations.

The invitation for EU membership negotiations represents a high recognition of Bulgaria's progress in establishing a competitive market and a democratic society. In 1998 political stability was already in place in Bulgaria. The 1998 Regular report from the European Commission (EC) on Bulgaria's progress towards accession confirmed that fact by concluding that "developments confirm that Bulgaria fulfils the Copenhagen political criteria". (*European Commission* 1998) The political stability was sustained in 1999 as well. Along with that, Bulgaria has consistently pursued its "principal foreign policy priority of rapid integration into European and Euro-Atlantic structures". (*National...* 1999, p. 6) The country's commitment to integration was clearly demonstrated during the Kosovo conflict "where Bulgaria projected an image of a stable country which respects the principles of democracy, the rule of law, market economy, was firmly supportive of all European Union (EU) actions and aligned itself to all EU and NATO positions". (*European Commission* 1999, p. 11) Bulgaria supported EU and Euro-Atlantic actions against Serbia despite the experienced negative economic impact of the Kosovo crisis (the estimated losses calculated at the end of March 1999 amounted to USD 6.5 million). (*Center for...* 1999, p. 1)

During the political process of strengthening democracy and establishing its institutions, Bulgaria has also achieved significant results in administrative reforms and reforms of the judiciary. The council of Ministers has adopted a Strategy for establishing a modern administrative system which aims at "establishing a responsible public administration, insulated from political interference and adequately remunerated". (www.government.bg. 1999) In this connection, the recently adopted Law on State Administration and the Civil Service Law represent major steps towards creating a proper legal framework ensuring an independent, efficient and professional civil service.

These administrative reforms have been accompanied by judiciary ones. A three-instance jurisprudence has been introduced. In addition to that, amendments to the Law on the Judiciary have brought the Prosecution Service into line with constitutional provisions. A Private Notary's Office has also been established.

Despite these positive reforms, the EC found deficiencies in the full independence of the judiciary, the material conditions of courts, the division of tasks between administrative staff and judges, etc. Therefore, it has recommended that the country develop "an overall strategy including measures to increase the effectiveness and transparency of the judicial system, and its capacity to enforce the acquis communautaire". (European Commission 1999, p. 12)

Another area that presents serious challenges for the country is the fight against corruption. According to the 1999 EC Report "the sectors most affected are customs, municipalities, medical services, universities, the police, taxation authorities". In this regard, the government has adopted a National strategy for combating Organized Crime and has ratified the major anti-corruption conventions.

The importance of the elimination of corruption and the improvement of the legal environment is once again emphasized by the government's ambition to attract foreign investments. From a fiscal point of view, foreign investors have been granted equal treatment with domestic investors. Still, transparency in state affairs and a stable legal environment play a decisive role in this process.

Bulgaria has undoubtedly achieved progress in the protection of human and political rights. In December 1998 the death penalty was abolished. The newly adopted Refugee Law provides a framework that allows asylum seekers to exercise their rights in a way compatible with European standards. (op. cit., p. 14) Moreover, all Bulgarians, regardless of ethnicity, have the right to stand for local and national elections.

As far as minority rights are concerned, the Turkish minority (about 9 percent of the population) continues to be fully integrated and represented in political life. However, the Roma minority (about 5 percent of the population) continues to suffer from discrimination. (op. cit., p. 15)

Taken as a whole, Bulgaria's political stability and democratic reforms have received international approval. Most importantly, the attained political consensus has been conductive to successful economic reforms. Thus by the end of 1999 Bulgaria had managed to stabilize its economy and, as part of this, its banking sector.

Economic overview of Bulgaria, August 1999

"After more than a year of rapid currency depreciation, high inflation, spiraling government debt, and output decline, the macroeconomic situation in Bulgaria has shown dramatic improvement and stability." (*OECD* 1999b, p. 23) The positive economic results were achieved only after the introduction in 1997 of a comprehensive reform programme supported by the IMF and the EBRD. The programme provided for the adoption of a currency board arrangement (CBA) accompanied by prudent fiscal and incomes policies. Alongside these developments, the reform-oriented government of the United Democratic Forces initiated radical structural reforms. As a result, the macroeconomic climate in the country improved substantially: GDP grew by 3.5 percent in 1998, inflation fell to 1 percent in 1998 after its value of 600 percent in 1997, while the consolidated budget deficit was entirely eliminated in 1998.

Furthermore, "the achievements in macroeconomic stabilization give Bulgaria a valuable opportunity to address substantial remaining needs in restructuring". (op. cit., p. 21) In this respect, the country has already achieved significant progress in the privatization process. At the end of August 1999, 42.3 percent of total public sector assets (as against 18 percent at the end of 1997) (*Bulgaria:...* 1999, p. 27) had been privatized. Some of the major privatization deals included the sale of the airline company Balkan, the oil refinery Neftochim, the steel giant Kremikovtsi, the copper smelter MDK Pirdop, and the sale to strategic foreign investors of four Bulgarian banks. In the first six months of 1999, total privatization deals amounted to sales of USD 281 million, (The World Bank... 1999, p. IV) while foreign direct investments reached USD 220 million. (Bulgaria:... 1999, p. 48) The structure of foreign investments reveals the attractiveness of different sectors, with wholesale trade attracting significant investment, followed by a mineral processing, pharmaceuticals and paper manufacturing. Germany continues to be the leading investor in Bulgaria, followed by Cyprus, the UK and Ireland.

However, the Kosovo crisis in the first half of 1999 aggravated the economic environment in the region, preventing Bulgaria from attracting more foreign investment or concluding a greater number of privatization deals. Once again, the Kosovo crisis, along with the acceleration of structural reforms associated with strong public sector downsizing, were the main reasons for the weaker economic performance of the country in 1999. As a result, Bulgaria registered a negative GDP growth rate (−0.7 percent year-on-year) (The World Bank... 1999, p. 1) during the first quarter of 1999. Despite the unfavourable external shocks, in the first half of 1999 the private sector registered a cumulative growth rate of 0.5 percent and contributed to 1.6 percent year-on-year GDP growth in the second quarter of 1999. (Ibid.)

Moreover, the BCC managed to conclude two more privatization deals in 1999—Expressbank and Hebrosbank were bought by foreign investors. Thus, half of the state-owned bank assets had been divested by the end of 1999.

Privatisation results

At present there are 34 commercial banks operating in Bulgaria. (OECD 1999a, p. 30) Approximately 24 percent of total bank assets have been sold to strategic foreign investors over the past two years.

The State first parted with the United Bulgarian Bank (UBB), which accounted for 10 percent of total assets. In August 1997, the UBB was bought by a consortium of the EBRD (35 percent), Bulbank (35 percent) and the U.S. Oppenheimer Co. (30 percent). (*Petrov* 1999, p. 8) Shortly after the acquisition, the BCC reported that the new majority shareholders had made a "significant capital infusion". (*Bank Consolidation*... 1999, p. 1) The authorities disclosed hardly any additional information concerning the deal.

The Bulgarian Post Bank (BPB) was the second privatized bank in Bulgaria. On 14 August 1998, the American Life Insurance Company (ALICO) and Consolidated Eurofinance Holdings (CEH) executed the Stock Purchase Agreement for the sale of all the BCC's shares, accounting to 78.23 percent of the total equity of the bank. The buyers also increased the capital of the bank with an injection of USD 20 million within 12 months after the closing. They also took on the obligation to preserve their stake in the bank for a minimum term of 7 years as well as to pay the BCC or the government 10 percent of their after-tax profit within the next 5 years.

On 24 September 1999 the BCC sold 98.9 percent of the capital of Expressbank to the French Societe Generale. According to the head of the BCC, the major criteria for this deal were the price and the need for strategic investor. The reported price for the sold capital amounted to USD 39.1 million.

The last bank to be privatized was the Plovdiv-based Hebrosbank. The sale contract was signed on 10 December 1999 and affirmed Regent Pacific Group as the new owner of the bank. Under the contract the buyer gets 97.57 percent of the bank's capital for a price of USD 23.5 million in cash. Regent Pacific has also agreed to invest USD 10 million, half of which will be deposited next year.

However, there are still three more state-owned banks to be privatized: Bulbank, accounting for 33 percent of total bank assets, the State Savings Bank (12 percent), and Biochim (5 percent). (Ibid.)

Concluding remarks

The high share of state ownership in the banking sector reflects the slowness of the privatization process. The main reason for the lack of progress was the lack of political will necessary for adopting a privatization strategy. In the first seven years of the transition, Bulgaria experienced constant political instability due to frequent changes of government. These governments demonstrated no serious commitment to economic reform. Moreover, various interest groups close to the political elites impeded bank privatization on purpose, hoping for future self-enrichment either by taking advantage of the lax lending policies or the non-transparent privatization procedures.

In addition to these political disadvantages, the financial state of banks was weak mainly because of the heavy burden of non-performing credits in their portfolios and also due to the lack of proper supervision. At the end of 1997 the share of loans classified as "losses" in the credit portfolio of commercial banks amounted to 13 percent of all assets (see *Table 2*). The low interest of foreign investors was further reduced by the absence of legal provisions granting banks the ability to collect collateral, remove poor management, or pursue bankruptcy through the courts.

However, it was after the government of the United Democratic Forces (UDF) came into power in 1997 that significant progress in restructuring the banking sector was registered. Moreover, the currency board adopted in July 1997 enforced sustainable financial discipline in the sector. In addition, the IMF-supported programme gave a decisive start to bank privatization, and currently four out of seven state-owned banks have been privatized.

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REVIEWS

LESSONS DRAWN FROM THE EU ACCESSION OF THREE SOUTH EUROPEAN STATES AND ITS EFFECT ON THEIR FOREIGN TRADE

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Preface

This study attempts to find out what can be learnt by countries wishing to join the EU from the experiences of three South European countries—Greece, Spain and Portugal—and what the medium-term effects of such an accession might be on the dynamics, on markets and on the commodity structure of their foreign trade. Three separate reports were prepared on each respective country—*Hamar* (1999), *Nagy* (1999) and *Somogyi* (1999)—and the present study is a summing up of these.

Six months in 1998 were devoted to this project. European integration processes in these three countries and their possible effects on Hungarian foreign trade were examined with future Hungarian EU membership in mind. We do not consider our work as having been completed. We would like to cover Ireland and Finland as well, in order to establish, with as much detail as possible, what effect EU participation is likely to have on the dynamics, commodity structure and market allocation of Hungarian foreign trade.

Introduction

The major issue in the early and mid-eighties, when Greece, Portugal and Spain joined the European Economic Community, was whether priority ought to be given to geographical extension—that is, to the admission of less developed countries—or to the deepening of integration (that is, to the further facilitation of the free flow of the factors of production within the Community, and to the creation of a currency union). The far-reaching decision to do both at the same time carried significant risks, many of them still unknown. There was no way of telling at the time how the three South European countries would stand up to the double shock of joining and of further reforms designed to lead to an integrated market. It could not be predicted whether less developed countries on the periphery would be pushed over the brink into decline or whether their modernisation might be accelerated.

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The opinion of economists was divided. Some argued that convergence, others that divergence would be strengthened. Optimists pointed to the advantages that more extensive and deeper integration would bring to all participants; pessimists feared the growing further relative pauperisation of the weaker countries on the periphery.

Who was right and what actually happened is obviously of extraordinary importance to countries in East Central Europe (ECE) wishing to join the EU. What lessons could be drawn from the experiences of countries that had joined earlier? The facts of more than fifteen years and the analyses published help to provide answers. This, however, cannot be summed up in a few words, unless we are satisfied with a "that depends" approach. It can be stated safely at the beginning that accession by less developed countries can have both significant favourable and unfavourable effects. When these accumulate over a period of time they can lead both to fast development and modernisation, as well as to greater difficulties and growing relative backwardness: in other words, results do not follow automatically. They depend largely on the economic policy implemented, on the introduction of reforms and on the way various societies and economies react to these policies and reforms.

A few examples can be given of both kinds of conclusion that can be reached. *Krugman and Venables* (1990) argue that a small highly projectionist economy on the periphery can gain significantly in economic welfare if it integrates into a larger and efficient economy. Low wage-levels are likely to attract—and in no small measure—both investments and the transfer of industrial production. As against this, one can argue that the end of the protection offered by high tariffs will make it possible for the developed countries to boost their industrial production and sales on the markets on the periphery. What is most likely is that both will occur in the course of the integration process, and since the result depends on the joint effect of many factors, one cannot predict which will prove to be stronger. Developments in the South-European countries provide numerous examples of both types of processes.

One of the principal objectives of integration is to eliminate market distortions. The advantages of this, however, only appear as parts of a comprehensive reform that cover the whole of the economy. Should such reforms be confined to certain areas, allowing distortions to survive elsewhere, then the advantages become uncertain—indeed, partial reforms can cause much damage. When the South European countries joined the Community, the reforms introduced covered only certain areas: chiefly the flow of goods, services and capital, but not, or only barely, the labour market, communal services and the financial sector. The coherence of the changes that went with accession was therefore not assured. By the time of the accession of the ECE countries, integration within the EU, as well as liberalisation, will already be much more extensive; at the same time, the institutions and legal systems of Soviet-type countries will need much greater changes. It is therefore impossible to predict with any degree of certainty to what extent the coherence of a system made up of partial reforms will, after accession, be in a position to assure the advantages that should accrue from integration.

A third example could be the efficient use of EU assistance. Structural funds can be equally used to offer advantages to rent-seeking state or private firms, or to boost productivity, improve the infrastructure and train the work force. Obviously vested interests compete in this respect, being out to influence economic policy to serve their own purposes. One cannot tell in advance who will attract the ear (and especially the help) of governments.

Examples can be multiplied, but perhaps this suffices to indicate both the possibilities opened up by accession and its risks. If most of these effects are favourable and their cumulative effect is synergetic, the comprehensive result may be a more efficient economy for the acceding country. In the opposite case, if competition cannot assert itself, and it does not prove possible to reallocate resources away from non-competitive activities to efficient ones, then the costs of accession could be great, and protracted over a longer period. Of the three countries in Southern Europe Spain tended to be an example of the first type, and so too was Portugal, albeit more slowly; Greece, for quite some time, exemplified the second.

The advantages of accession to Europe

Various less developed countries are eager to participate in European economic integration and to join the EU in the hope that this will speed up growth, thus allowing them to catch up with the more developed economies. This was also the case with the South European countries where, at the time of accession, per capita income levels were well below those in the European Economic Community (EEC). True, they had grown relatively fast in the sixties and seventies but afterwards their growth rate slowed down and their development remained well below the average of West European countries. After accession, the growth rate in Spain and Portugal exceeded the West European average and they made significant progress in closing the gap; in contrast to this, there was stagnation in Greece (which had joined first). This contrast in itself prompts one to ask on what, in any particular country, the exploitation of the advantages of integration depends.

If foreign exchange rates are stable and trade barriers diminish significantly or disappear, then prices will gradually level out in the medium-term and per capita income differences will diminish. What is important for Hungary and other countries joining later is the rate and the length of time over which this happens; furthermore, also it is an issue as to whether the process will be spontaneous, or will other factors and instruments be needed to give an impetus to this levelling up.

According to *Larre and Torres* (1991) per capita incomes in every OECD country came closer to those in the USA (the richest country at the time) between 1960 and 1990. There were significant differences among countries, but the trend was more remarkable in the less developed countries than in those where incomes were higher.[1] Significant differences between countries makes it possible to examine those structural and institutional factors which are responsible for these deviations. The three South European economies were reckoned to be among the most backward OECD members at the time. The differences in their development may therefore reveal the effective role of particular factors.

Between 1960 and 1973, per capita incomes in all three countries grew at a faster rate than in the more developed OECD countries. Therefore a trend indicating catching up was discernible at that time. The unfavourable effect of the first oil-price explosion on development in the South European countries was, however, much more severe and protracted than in more developed countries. The result was that the process of catching up was interrupted for around ten years. This was otherwise in accordance with the generally observable fact that economies tend to converge in periods of expansion—at the very least, they do so more forcefully at such times. At times of stagnation or decline convergence slows down or grinds to a halt. (*Darwic and Nguyen* 1989)

In the early eighties problems with macroeconomic equilibrium grew more serious in all the three South European countries; the second oil-price explosion was partially responsible for this. In Spain unemployment rose to above twenty percent and stayed at this level. Inflation was high in Greece and Portugal and both balance of payments and budget deficits grew. In the middle eighties, however, starting with access to the EC, the Spanish and Portuguese economies once again found themselves on a growth path and signs of catching up with the more developed countries were once again discernible. However, growth rates in Greece remainded below those in Western Europe and as a consequence her relative position did not improve.

Theoretically, it is easy to explain why access to the EU should increase incomes both on the demand and the supply side. Once barriers to trade come down, both the average and marginal costs of production decline in proportion to the share of imported materials used, and this increases the return on capital. In addition to the supply side effect demand also grows. The price level of imported goods declines as a result of liberalisation, and this leads to a growth in demand.

Gradual access to the EU has many further indirect effects. As competition becomes stronger, resources flow into industries and activities that offer comparative advantages and this improves efficiency in the whole competitive sector. Con-

[1] It should be stressed that this only applied to OECD countries. No convergence of incomes or the standard of living could be observed in the case of so-called "developing countries". (*Helliwell et al.* 1990).

centrating production in fewer competitive firms leads to economies of scale and lower costs. A more entrepreneur-friendly institutional environment facilitates the founding of new firms and intensifies their competition. Improvements in efficiency largely depend on the degree to which domestic products can be substituted by imported goods and on the mobility of the factors of production—that is, on how easily they flow between industries and countries. This refers to more than the mobility of labour or the flow of capital, and barriers in their way. The ability to adjust (on the part of communal goods, such as the infrastructure) is part of this, and so are systems of education and retraining.

From a macroeconomic point of view, the breaking down of market barriers means that, as the prices of traded goods tend to the same level in different countries, those of non-tradable goods and services remain lower in less developed countries. As a result—as Béla *Balassa* (1964) has shown—per capita incomes and purchasing power parity are in an inverse relationship. Furthermore, relative wage levels may well differ between countries in proportion with the productivity of labour. However, as the growth of productivity accelerates in less developed countries following integration, it can be expected that after accession real wages will grow faster than in the other countries of the Union. Meanwhile, the consumer price level will also grow relatively fast, since the relative prices of non-tradable goods and services will approach those of products in the competitive sector. As a result, in the catching-up period, the rate at which prices grow will be higher in the less developed countries. This process can be moderated if their currencies are allowed to appreciate to a certain extent.

It follows from theoretical considerations that catching up with the more developed countries through integration takes a longer time, that it is an uneven process and that the rate can differ considerably from country to country. All this depends on the way the reforms are implemented and on the institutional environment. The two principal motors of the process of catching up are technological progress and capital accumulation; beside these, however, the structure of institutions and the development and flexibility of market mechanisms are very significant indeed. All these factors can be boosted or curbed by state intervention and by legal or economic policy means (not only nationally, but also regionally—i.e. by the communal policy of the EU).

If we compare the theoretical considerations with what actually happened in the South European countries following their accession, we can ascertain that numerous factors actually and significantly contributed to the improvement of their relative position. A few are mentioned below:

— On the labour market, a significant mobility could be observed from rural areas to industrial centres and to more developed member countries of the Union. At the same time wages rose relatively slowly and trade unions' and workers' rights were limited. The low level of education and skills of a great part of the population was also a serious obstacle in the way of technological progress and specialisation.

— A considerable amount of FDI was invested in all three countries, attracted by low wages, by different allowances and by political stability.

— The growing openness of the economy and a boom in Western Europe led to relatively high growth in exports over a longer period.

— The high level of investments was made possible not only by the inflow of foreign capital but also by the high ratio of domestic savings and transfers from guest-workers abroad.

— The transition period was characterised by a dual structure of production: the exporting sector largely consisted of small- and medium-sized firms which were labour-intensive, in competition with imports, and open to foreign investors. Besides these there was a wholly or partially state owned sector, operating chiefly in mining and heavy industry, which was protected both against competition and foreign investments.

According to OECD investigations, since the mid-eighties, the accelerated process of catching up—observable in the two Iberian countries—was due, in Spain, more to the growth in employment and less to a fast growth in productivity. In the case of Portugal, the higher productivity of all the factors of production proved to be the motor of development. They found that in Greece all the factors examined contributed to the stagnation or relative decline of per capita incomes. (Larre and Torres 1991, p. 192)

The characteristics of the South European countries

Right up to the mid-eighties Spain and Greece remained relatively protected against foreign competition—albeit Spain had already entered into a trade agreement with the European Community in 1970 and Greece had been admitted as a member in 1981. A highly asymmetric relationship was maintained for both countries: the level of tariffs (or of special supplementary taxes and dues) remained relatively high in both countries but the EEC either abolished or diminished import restrictions on a large proportion of their export goods. It is this protection which explains why the Greek production structure—and the way the country's trade was specialised—remained unchanged for so long and why Spain also only changed slowly at that time.

The situation was different in Portugal. Already in the early eighties, thanks to EFTA membership and intensive trade with the country's colonies and with Brazil, foreign trade was as open as it was in the West European countries. At the time of accession to the EEC Portuguese customs duties averaged 5 percent, as against 17 percent in Spain. It is true, however, that an import licensing system and many quantitative restrictions were still in operation. An important characteristic of all three countries at the time of their accession was the relatively large share of agriculture, with regard to both production and employment. This is another way in which they resemble those ECE countries that are preparing for accession. Thus, in 1980, agricultural employment in Greece and Portugal was double the OECD average, and the share of agriculture within GDP was two or three times as high. The differences were smaller for Spain, but they were still significant.

Naturally, all this was in close relation to the low productivity in agriculture, to the strongly subsidised prices of agricultural products, to the low level of qualifications of agricultural labour, to obsolete technologies, to a backward rural infrastructure and to inefficient marketing.

The underdevelopment of their financial markets was a characteristic feature of their backwardness. Competition between banks was minimal (that is, if it existed at all). There was much interference by the state in the business of financial institutions, particularly in credit-granting proceedings, the capital market lacked scope, savings possibilities were limited, interest rates were centrally determined and state budget support for low interest credits was widespread. All this naturally distorted the allocation of resources, diminished efficiency, reduced returns on capital and incomes, and increased transaction costs.

In the South European countries the level of both the social and the economic infrastructure was well below that of other members of the European Economic Community and this was a serious barrier to their catching up. Because of the backwardness of social insurance provisions, health and social indices were all much more unfavourable than in the more developed European countries. Educational standards and the proportion of skilled workers in the labour force were also low. Economic development was handicapped and investments were made more costly and difficult by underdevelopment in transportation and particularly telecommunications. Overcoming backwardness in the infrastructure—be it in social insurance, education and training, or communications—is a costly business, requiring considerable investment. Securing the necessary resources is difficult: the greater the backwardness, the greater the difficulty. Hence it all takes much time.

The above details help to indicate, on the one hand, how alike are the socio-economic characteristics of the South European countries which joined the European integration some time ago and those of the ECE countries which are now preparing for accession. On the other hand, it is also evident that there are great differences—for instance, in the openness of the economy, or in the provisions of social insurance, or in standards of education and training.

Reforms following accession

The accession of the South European countries was followed by far-reaching reforms. On the one hand, market institutions had to be created and the operational conditions of firms had to be liberalised in economies that had earlier been inwardlooking and closely controlled by the state; on the other hand, welfare systems had to be introduced or extended.

Joining the EEC implied the liberalisation of trade, but it was a gradual process in the three South European countries. A fairly long period of transition, during which barriers to trade had to be demolished, was allowed to all three countries in accordance with pre-accession trade agreements, and then by the articles of accession. There was differentiation with regard to the respective countries and their products. In conjunction with trade liberalisation, microeconomic reform programmes were implemented which covered a wide range of firms and which facilitated the structural adjustment of industries that found themselves in difficulties as a result of import competition. The reorganisation of industries that would be threatened by imports was started in Spain in the early eighties. Reforms of the labour market moderated pressure due to wage rises. In Portugal market economy reforms got off the ground in the mid-eighties and they also covered the financial sector. Greece showed considerable reluctance in abolishing barriers to trade, and measures to further structural adjustment were introduced much later than in the other two countries.

Numerous important changes followed the accession of Spain and Portugal in 1986. These will be discussed in greater detail later. At this point a few will be mentioned, particularly those which made a major impact on their trade.

— Spain abolished all quantitative restrictions and undertook to reduce by half—within three years—the difference between its own and EEC outside tariffs.

— Portugal abolished its import licensing system, the special dues on imports, some of the quotas and undertook to put an end to all quantitative restrictions within seven years.

— Greece did not abolish its trade barriers before the other two countries had done so, even though she had joined the community five years before them. She started to apply EEC tariffs in 1986, and abolished a special tax on imported goods only in 1989.

Spain and Portugal introduced a uniform VAT in 1986 and this replaced earlier, highly differentiated taxes. This automatically reduced a significant number of invisible export subsidies and limitations on imports. Greece introduced a VAT a year later but the gradual elimination of subsidies, tax concessions and favourable credits granted to exporters took much longer.

Right from the start of the eighties the EEC gradually reduced the list of goods imported form South European countries to which import quotas were applied. The end of restrictions on trade (that came with accession) produced significant changes in the direction and structure of trade flows. In all three countries imports grew faster than demand and trade creation was stronger than trade diversion, particularly in Spain and Portugal. At the same time, the ratio of exports within total production grew, at first in Portugal and, after a certain delay, in the other two countries too.

Pre- and post-accession reforms naturally covered a much wider field than simply putting an end to trade barriers. It is largely the implementation of these reforms which determines the results integration can produce as regards changes in the structure and dynamics of trade, the growth of competitiveness and the exploitation of comparative advantages. It is thus highly important, for example, when and how obstacles to capital flow in both directions are abolished. It can be presumed, for instance, that the better results achieved by Spain are connected with the fact that limitations on the inflow of capital were ended earlier, and more radically than in Portugal.

Reforms in skills training and regulation of the labour market in South European countries were of considerable importance for boosting economic growth and therefore for the process of catching up with the more developed countries. Retraining programmes, and the introduction of temporary work-contracts, part-time employment and the introduction of unemployment benefit systems considerably increased the adjustment of labour to changes in the demand for it. All this smoothed the transition in the structure of production and foreign trade in Spain and Portugal. In Greece, however, changes in the labour market were much delayed, and this may well have been a reason why she fell behind the other two countries.

Certain important details of the reform process, such as the transformation of the financial sector, and more rational and efficient price formation, financing and credit arrangements, and the exercise of property rights in state-owned enterprises cannot be discussed in detail here (albeit they, too, play a considerable role in the process made by these three countries). Both with regard to reforms in the banking and insurance sector, and in the transformation of the state-owned sector, it was clear that changes in the two Iberian countries were much faster than in Greece, where hardly anything happened in this respect.

After accession all three countries received considerable financial support to further the modernisation of their economies. Its effectiveness depended on the rationality of how the respective governments used such support, and how far it served the acceleration of economic progress. Transfers from EEC structural funds, the most significant item of support, made up 0.5 percent of Spanish and 1.5–2 percent of Greek and Portuguese GDP in 1988 (Larre and Torres 1991, p. 185)—i.e. a considerable sum. Within this there were special allocations for development of the infrastructure, for reforms in the training of skilled labour and employment, for the structural adjustment of agriculture, and for various concrete industrial or agricultural projects. The recipient countries also had to contribute to the projects supported by the Community (this, at certain times, implied a heavy burden for their respective public expenditures).

It would be difficult to measure the extent to which support from EU structural funds contributed to catching up and modernisation but their significance is beyond all doubt. It is certainly greater than the sum total of transfers and credits, since it served to concentrate the attention of governments and proved an incentive for reform. With respect to the efficiency of support by the EU, economists whom we consulted all stressed the responsibility of governments. Given the huge volume of money transfers, there is considerable danger that vested interests having good contracts with political parties or government agencies will try to turn many of these transfers to their own purposes, or else certain corrupt politicians or public servants will allocate them according their own interests. The EU endeavours to control the use of the structural funds, but this in no way offers sufficient guarantees. Transparency is therefore very important in all such transactions; the public and the press must be able to keep an eye on the use made of the funds. Rules and regulations must govern public acquisitions and tenders. These rules must be enforced, and wherever it is possible, the participants should compete with each other.

Far-reaching reforms introduced in conjunction with accession produced unambiguously sound results relatively quickly in Spain and Portugal. They boosted investments and furthered the transformation of the production and foreign trade structure of each country in a manner which made good use of the characteristics of the respective countries. Earlier, in all three countries, specialisation in production and foreign trade tended to reflect the distribution of tariffs and subsidies. Their moderation or abolition boosted average productivity. Production and exports grew in those industries which were internationally competitive, or became competitive as a result of technological changes and new investments. The changes in the production structure of industry and the growth of production corresponded to the genuine comparative advantages of the countries; these supported the theory that catching up with the developed economies was, largely, an endogenous process. (*Abramovitz* 1986) In many respects it depended on changes in outside conditions, but it was basically due to the domestic economic and institutional structure, the allocation of resources, and the development of the resources themselves in what had earlier been backward countries. The fact that the structure of production in Greece remained virtually unchanged for some time clearly shows what happens if the appropriate reforms are not introduced (in spite of the accession), and protectionism and overregulation by the state continue.

Soundly implemented structural reforms can be quantified in terms of the export successes of the two Iberian countries. The commodity structure of exports has changed, more of such goods are produced for which demand has grown relatively fast on the market, and exports are now directed to markets where their products were or have become competitive. At the same time, the quality, competitiveness and marketing of products have significantly improved.[2] The joint effect has been a significant improvement in the terms of trade. In comparison with the accession of other countries, thanks to structural changes, the higher the tariff levels

[2] See the section on the effect of EEC accession on the dynamics and structure of foreign trade for a more detailed discussion.

before accession and the more quotas which hindered trade flows, the greater the favourable effects. The only exception is agriculture, where the advantages were less apparent than in industry. One reason for this could be that common EEC agricultural tariffs were higher in many cases than those of Spain and Portugal had been before accession. As against this, the market share of Greek exports declined for some time, since she maintained her trade barriers. As a result, relatively few resources flowed into the country, and their allocation remained inefficient too.

The analyses lead to the conclusion that the significant difference observable in the improvements of standards of living between the two Iberian countries and Greece following accession—particularly bearing in mind the much earlier accession of Greece—was obviously due to differences in the introduction and application of reforms and particularly to trade liberalisation. Several economists have pointed out that more could have been done in the way of catching up if the improvements in the social and economic infrastructure had been faster. Many consider the rate of improvements in this field to be unsatisfactory, even if changes in the infrastructure are significantly more difficult and slower than, for example, in industrial investments.

Unsatisfactory infrastructural developments in roads, rail and telecommunications, and the mainly metropolitan character of what happened, led to the result that foreign investments were largely concentrated there, with the consequence of even greater overcrowding and a growing gap between the metropolis and more backward rural areas. The slowness of improvements in education and training and the low mobility of much of the work force led to both greater unemployment and a greater shortage in skilled labour. An important conclusion that has to be drawn is that catching up with developed welfare states largely depends on improvements in the infrastructure and in the flexibility of labour; these all demand a greater allocation of funds within the budget. In other words, in this field at least, the duties of the state do not diminish but grow. Coping with all this without increasing budget deficits is a serious problem for all governments. The only escape from the horns of this dilemma is more severe budgetary control in many fields of state expenditure, as well as a reduction in the costs of certain expensive state activities, such as the armed forces, or the secret services.

The consequences of the EEC accession of three South European states

The conditions of accession to the West European integration by three South European countries, and what this accession has resulted in, will be briefly summed up below. Only a few major questions will be discussed here; detailed analyses can be found in the three studies mentioned in the introduction.

SPAIN

Of the three countries included in the present survey Spain is undoubtedly the least "southern"—that is, it was economically the most developed at the time of accession. Per capita income was significantly higher than in Greece, Portugal or Ireland, but as regards the rate of inflation, indebtedness and numerous other indices of social development, it also stood closer to the other countries in the Community. In many respects Spain's development was relatively close to that of Hungary. What makes the likeness even closer is that nine years passed between the decision to join and full membership. In Hungary's case the timetable of accession is likely to demand even more time.

An essential difference is that Hungary can only reckon with fewer exemptions affecting a much narrower area within the economy, and on shorter periods of toleration. The situation differs also in that Spain only had to liberalise trade at the time of accession, and even then, like Portugal, Spain was granted a seven-year period of transition in agriculture (Portugal was given ten years) in which adjustments could be effected. In Hungary the liberalisation of foreign trade took place relatively quickly, obviously well before accession, between 1989 and 1991.[3] The liberalisation of foreign capital flows also occurred at a much earlier stage in Hungary than in Spain.

A peculiarity of the European integration of the Spanish economy is that, after a long-lasting isolation, the policy of opening up was first applied to capital flows, before liberalising trade in commodities. This ran counter to the advice of the textbooks and usual development policies. The extent to which this contributed to success is still an open question. There can be no doubt that the influx of foreign capital had a considerable role in the development of tourism and of the country's infrastructure. These positive developments snowballed in much of the economy.

Before accession Spain experienced a considerable and chronic series of balance of trade deficits. These were only partially counterbalanced by income from tourism and the remittances of Spaniards working abroad. After accession income from exports started to grow quickly and the balance of trade deficit diminished. Compared to the other South European countries Spain was less open, tariffs were nominally and effectively high. In a certain sense this had the "advantage" that the exploitation of comparative advantages accruing from the liberalisation of trade more forcefully accelerated growth once the obstacles to adjustment were removed.

Judit Hamar's (1999) analysis allows us to conclude that progress in the thirteen years since EEC accession exceeded expectations. In recent years growth in Spain has been stable, at a rate higher than the EU average. Economic activity has steadily accelerated since 1995 and, according to OECD forecasts Spain is likely

[3] See in more detail: *Lányi and Szabó* (1993) and Nagy (1995). There have been retreats in the degree of liberalisation since then, but there has been no retraction so far. See Hamar (1997).

to be amongst the fastest growing economies in the immediate future. (*OECD* 1998a) The rate of inflation has been significantly moderated and it is lower than in the other South European countries.

Outstandingly high unemployment, that has been typical of Spain for many decades, still causes anxiety albeit some slow improvement has been discernible in recent years. In spite of large-scale unemployment wage expectations have only slowly adjusted to the low rate of inflation and real wages have significantly risen. Unit labour costs have increased more than was the case for the major trading partners but, owing to the effective devaluation of the peseta, this had no significant influence on international competitiveness.

Membership of the EU has had the result that, since the mid-eighties, consumption has grown at a rate never experienced before. Owing to much livelier activity in the private sector, household real incomes have increased considerably, per capita GDP (USD 14.272) reached 67 percent of the German level, and Spain is close to the U. K. with respect to purchasing power parity. Not a single other country among those which joined the European integration displayed such a fast growth in incomes. As a result of income growth, savings have also significantly increased in Spain, livening up investment activities. Investments have risen to 22 percent of GDP, which is high by OECD standards. Since the eighties capacity utilisation has reached its highest level. Returns on capital are favourable and the prospects for future high profits are promising.

To sum up: in Spain, forceful and broad-based economic growth has created many new jobs. Inflation has been low and the current balance of payments has been maintained in equilibrium. The favourable results have been backed by economic policy, primarily by financial consolidation. As a result, financial markets were responsible for enabling Spanish accession to the European Financial Union. The synergistic effect of these factors has boosted confidence in the economy on the part of consumers and business alike; such confidence is unprecedented.

PORTUGAL

Portugal is the "westernmost" of the three South European countries, but as regards development and integration successes, it finds itself somewhere in the middle. Analyses (*Macedo* 1990; Hamar 1993; *Kovács* 1994; Nagy 1999) show that for some time after accession, the government (as was the case in Britain) related to the integration with a certain ambiguity. The reasons were however, totally different. In the mid-seventies, before the revolution—which had overturned the right-wing dictatorship of Salazar—the idea of joining the European integration had already ripened in Portugal, but the revolution represented a U-turn. The new regime opposed capitalism of the Western kind and favoured nationalisation and a centrally planned economy. This period did not last long, but it resulted in a huge state sector, which demonstrated great rigidity for a long time.

The conflict between the political aims of the revolution and the liberalisation linked to integration led to difficulties in the restructuring of production and foreign trade. All the same, the accession of Portugal to the EEC is regarded by many as a success story given that per capita incomes, on purchasing power parity (which in 1986 were barely more than half the EEC average) had grown to close to 70 percent of the average of the fifteen EU countries by 1997. (*Fontoura* 1998; *OECD* 1998b) Numerous other factors and results prompt a favourable estimate of both what has been achieved so far and of the present situation.

Since the mid-nineties, the Portuguese economy has enjoyed a period of unusually well-balanced growth. This has led to a significant improvement in all the basic economic indices. Confidence in economic policy has been boosted by the stability of the currency and diminishing budget deficits. Portugal satisfied the Maastricht criteria and became a founding member of the European Financial Union. According to the forecasts, the next two years will also see further strong growth, and declining unemployment which will not be accompanied by a growth in inflation.

One of the explanations of this success is the greater flexibility of the labour force, in spite of the fact that post-revolutionary regulations have made redundancies very difficult. Employers have responded by making greater use of extendable short-term work-contracts. This has relaxed the rigidity of the labour market. Both this, and large-scale employment abroad, explain why Portuguese unemployment is particularly low in the European context—in sharp contrast with the situation in Spain. Another explanation of the successes is that wage-levels are well below those in the main European trading partners, even after the above-mentioned fast growth in per capita incomes. This helps to make Portuguese exports competitive, and produces relatively large returns on capital in spite of low productivity. It also attracts foreign investments and helps with the privatisation of state enterprises.

The speedy economic growth of Portugal compared to other EU countries spurs on both domestic demand and exports. The capacity utilisation in industry is over 80 percent which, naturally, favours investments. The latter have also become an important motor of economic growth. The rise in domestic consumption is due to the lower rate of inflation, higher rates of employment and more remittances from abroad. The expected further rise in demand offers an incentive to investments. Returns on capital are also rising steadily, following the relative reduction in unit labour costs and the better utilisation of capacities.

Difficulties in the Portuguese adaptation to European integration largely derive from the dual structure of the economy. Administrative regulation covering a large area of the economy has led to a dual structure in which a competitive sector and an inflexible state sector, protected against competition, have coexisted. The result has been a considerable deterioration in efficiency within the economy as a whole. The liberalisation of trade made it apparent that there were industries in Portugal which were competitive on the international market but, at the same time, the industrial policy of the government has maintained and protected industrial conglomerates that have been kept alive by privileged trade with Portuguese colonies in Africa. After decolonisation, their non-competitiveness became obvious, and this was one of the reasons why they were nationalised. Thus, "leftist" demands for socialism coincided with privileged vested interests—those of non-competitive large enterprises. That is why restructuring and modernisation of industry is so important in Portugal, demanding privatisation and considerable investments in a smaller measure but not unlike the case in the former socialist countries (*Iking* 1997; *Somogyi* 1996). This process has been considerably accelerated in recent years but Portuguese economists argue that much remains to be done in this field.

Complications in Portugal's adaptation to Europe were largely due to the fact that, in contrast to Spain, the liberalisation of the financial sector and capital flows suffered considerable delays. The large banks were state-owned and their funding was difficult and costly since a large part of the credits granted to non-competitive, nationalised large enterprises had to be written off. Portuguese experience seems to be similar to what is expected with regard to the problems of adjustment of the ECE countries. This allow one to conclude that, although joining the EU narrows and limits the options open to the economic policy of a particular country, it does not put an end to them.

GREECE

Greece is considered the "easternmost" of the South European countries which also suggests that of these three it has proved the least successful in its adjustment to the European integration. (Somogyi 1999; *Bliss and Macedo* 1990 Introduction; *Babanaszisz* 1998; *Katseli* 1990) This is all the more surprising since she was the first, in 1961, to enter into an association agreement with the EEC, and the first of the less developed South European countries to achieve full membership in 1981. In other words, she had twenty years to get ready. At the time of accession Greece was relatively backward, both socially and economically, compared to the countries of Western Europe, and early joining chiefly had political and strategic reasons which motivated both Greece and the Community. Both tensions with Turkey over Cyprus and the threat of a new military dictatorship were sensitive issues. Yet the growth of Cold War tensions, the occupation of Afghanistan and the new oil price explosion stressed the strategic importance of the country.

Neither the EEC nor Greece was properly prepared for accession. At the time of the "Colonels", Greece was isolated internationally and in practice suspended the timetable fixed in the association agreement. The EEC did not insist on it either, as it was not prepared for the reception of economically and politically underdeveloped countries. What was perhaps even more important was that the government of the left, which came to power at about the same time as the accession, initiated an income- and consumption-minded welfare policy without creating the conditions for higher economic performance by liberalisation and improved competitiveness. In this way Greece lost touch with Western European developments, went in the opposite direction, and cut off the sources that might have made its catching up possible. The correction initiated around 1990 (which, apparently, still enjoys wide public support) has proved to be a long and bumpy road.

Later economic troubles should not allow one to forget that the Greek economy between the mid-fifties and the mid-seventies had experienced considerable growth. Greece was then reckoned as being one of those countries which quickly rose out of a situation of economic backwardness; she was regarded as one of the success stories of the time. Much has been written about the causes of the lasting weakness of the competitiveness of Greek firms after such an auspicious start, that long absence of adjustment to the European integration, and the stagnation of the economy. Most studies have looked at the differences between the other two South European countries, especially with respect to the "state-corporative" character of the Greek economy. These focus on the fact that the Greek economy was directed by oligarchies made up of state agencies, financial institutions, and traditional families of industrialists. In such a system the dividing line between the public and the private sphere was obscured, the state forcefully interfered in the operation of private firms, and groups of financiers and industrialists were able to influence state regulations.

According to *Katzenstein* (1983) state corporativism can be described as collective conflict management. The state, the banks, the business community, the trades unions and the political parties make decisions and implement them largely with the help of a structured and overlapping network of political interdependencies. This is based on the idea of a powerful social partnership. Decisions are made by the government, by the banks and by leading businessmen. They stand for the collectively formulated interests of highly centralised institutions, making it impossible for a large proportion of the population to assert their own interests.

The politically controlled credit policy of state-owned banks was the instrument through which overindebted firms governed by industrialist families, long overdue for restructuring, obtained ongoing access to resources. This naturally led to what *Kornai* (1986) has described as soft budget constraints, paralysing those aspects of the market mechanism which make for dynamic development. It was not the need for competitiveness that determined the behaviour of firms, and efficiency was not the major condition of survival.

Accession to the EEC, and the reforms which adjustment to the rules of the community demanded, was a major threat to the industries enjoying protection. State corporatist control, support for large firms in the red, a *dirigiste* credit policy and soft budget constraints would all have to be abandoned. It is not surprising, therefore, that resistance was strong and "successful" for some time. As a result of the incomes policy of the Socialist government, which came to power at the time of the accession, there was a boost in domestic consumption. However, this largely demonstrated in a growing demand for imported goods. Domestic firms responded to the loss in markets by throttling production and investments.

The new government opted for expansion, using the budget and monetary and incomes policy for this purpose. Wages, pensions and other benefits were increased. The role of the state in the economy was boosted and nationalisations were carried out. While incomes grew, this policy naturally led to huge budgetary and current balance of payments deficits, inflation accelerated, the conditions of operation in the entrepreneurial sphere significantly deteriorated, production stagnated, unemployment increased, the drachma lost its value, exports lost their earlier dynamism and the country's indebtedness got larger.

All this indicates there was an absence of changes in the structure of production and of adjustment to the European integration. Greece isolated itself from trends in the world economy right up to the mid-eighties. The trade-creating effects of EEC accession did not occur in practice. Support by the Community—amounting to close on USD 3 billion in 1990—did not contribute significantly to the modernisation of either industry or agriculture, and only a small proportion was used in infrastructural development. The unchanged industrial structure naturally imposed its mark on the composition of exports. Products embodying low skills and quality but requiring much labour and raw materials increased their share in exports. In contrast to the situations in Spain and Portugal, high-tech goods based on R&D activity hardly figured in Greek exports. As a consequence, what had been achieved in the process of catching up with developed countries up to the mid-seventies largely fell apart.

The conservative government, which came to power in the early nineties, carried out an economic U-turn. The aim was to cope with long-drawn-out equilibrium problems and to give Greece a chance to meet the Maastricht criteria. Thus there were changes not only in economic policy but also in attitudes to the EU. Greece abandoned her separate ways and committed herself to closer participation in the integration. The 1994–1999 convergence programme aimed to limit budgetary deficits, to maintain stable exchange rates and to control wage-levels.

The change in economic policy looks promising, inflation has been significantly reduced (the consumer price index was 5.4 percent in the early summer of 1997 and 4.5 percent at the beginning of 1998), the budget deficit has been moderated (declining from the previous year's 7.5 percent of GDP to 4.2 percent in 1997) and economic growth, for the first time in many years, has been higher than the EU average (GDP rose by 3.5 percent in 1997, as against the EU average of 2.6 percent). Expansion of domestic demand has been the chief motor of growth, including public investments supported by the EU. Stabilisation has no doubt produced results, but real modernisation of the Greek economy and catching up with the more developed countries in Europe demands an accelerated continuation of already initiated reforms and primarily the liquidation of the surviving remnants of state corporativism. It is an open question whether the government can summon the necessary strength and social support for its programme.

The effect of EEC accession on the dynamics and structure of foreign trade in the three South European countries

As already mentioned, one of the aims of this research project is to examine the medium term effects of accession to the EEC on the market and commodity structure of foreign trade and on the acceleration of economic growth with respect to three South European countries. Previously protectionist, backward economies have been significantly transformed by integration and by removing barriers to trade. On the one hand, accession transforms the structure of trade with other member countries; exports grow and some domestic production is substituted by imports. On the other, with common tariff regulations, trade flows are directed to member countries of the Union at the expense of other regions.

The results are described in detail in the three studies mentioned in the preface. In this study the principal features of the changes in the three countries are compared. The details covered by the analysis are varied in their nature: first we considered the two main commodity groups (primary goods and manufactures) and then we worked in terms of the SITC single digit and double digit commodity breakdown employed by the UN trade statistics. The first includes nine, and the latter seventy-two commodity groups.[4]

In the seven years between 1988 and 1995 (which were surveyed by us) world trade grew by 180 percent (EU trade somewhat more slowly) exports by 173 percent and imports by 167 percent. As *Table 1* shows, Spanish and Portuguese exports and imports all grew much faster than world trade and EU trade. This was obviously connected with the trade-creating and growth-boosting effect of accession. It can also be seen that Greek trade growth did not display the dynamism of either world or EU trade. A breakdown by commodity groups shows that in the exports of Spain and Portugal the share of manufactures grew much faster than that of primary goods; in Greece the situation was reversed, with the dynamism of primary products exceeding that of manufactures.

[4] Data are taken from the OECD CD-rom "International trade by commodity statistics", March 1997, which gives trade figures in current US dollars for the 1988–1995 period. OECD distribution by zone had to be altered at several points. For details, see Nagy 1999, p. 22. For Greece, this source only contains data up to 1994.

Table 1

Growth of trade of the South European countries between 1988 and 1995 (1988=100)

Countries	Regions	Exports			Imports		
		Primary goods	Manu- factures	Total	Primary goods	Manu- factures	Total
Spain	Total world	179	243	226	174	194	188
	EU 15	192	252	237	231	198	203
Portugal	Total world	143	223	206	173	189	184
	EU 15	154	230	216	235	190	196
Greece*	Total world	221	146	173	176	174	175
	EU 15	162	133	143	164	183	178

*In the case of Greece 1994

It is striking that in the imports from EU countries, primary products grew faster than manufactures in the respective cases of Spain and Portugal. In Greece the situation was reversed in this respect also.

Table 2

The share of the EU in the trade of the South European countries in 1988 and 1995 (percentages)

Countries	Exports						Imports					
	Primary goods		Manu- factures		Total		Primary goods		Manu- factures		Total	
	1988	1995	1988	1995	1988	1995	1988	1995	1988	1995	1988	1995
Spain	68	73	68	71	68	71	31	41	73	74	60	65
Portugal	70	75	80	83	78	82	34	46	83	84	70	75
Greece*	67	49	69	63	68	57	58	54	70	74	67	68

*In the case of Greece in 1988 and 1994

Trade with EU countries already had a determinant role in all three countries in 1988. The share of EU markets grew in the case of Spanish and Portuguese exports, but it significantly diminished in the case of Greek exports (*Table 2*. Characteristically, the EU share is smaller in imports than in exports in the case of the two Iberian countries (which smoothly adjusted to the integration); once again, the situation was reversed in the case of Greece. Western Europe takes up a much smaller share of her exports (57 percent) than it fills in her imports (68 percent).

Table 3 displays the commodity structure and its changes with regard to the exports of these three countries in terms of nine commodity groups according

Table 3

Export commodity shares of the South European countries in 1988 and 1995 (in percent)

SITC	Commodity groups	Spain				Portugal				Greece			
		Total world		EU 15		Total world		EU 15		Total world		EU 15	
		1988	1995	1988	1995	1988	1995	1988	1995	1988	1994	1988	1994
0	Food and live animals	13.9	12.9	15.3	14.6	4.16	4.14	3.08	3.90	17.72	20.00	20.73	22.28
1	Beverages and tobacco	1.7	1.5	1.4	1.5	3.48	2.58	3.43	2.31	5.48	5.47	4.99	3.38
2	Crude materials	4.0	2.6	4.3	2.7	9.62	6.48	10.35	6.27	6.11	6.36	4.80	5.91
3	Mineral fuels	4.3	2.2	3.0	1.2	2.92	0.42	1.25	0.50	5.18	10.30	2.96	2.24
4	Animal and vegetable oils	1.7	1.1	1.5	0.8	0.43	0.67	0.27	0.15	1.39	3.65	1.57	5.81
PRIMARY PRODUCTS		25.6	20.2	25.6	20.8	20.62	14.29	18.38	13.14	35.87	45.78	35.05	39.63
5	Chemicals products	8.9	8.6	7.5	7.9	5.98	5.00	5.28	4.87	3.92	4.26	1.90	3.10
6	Manufactured goods	21.4	19.7	19.0	18.6	24.46	23.44	23.48	22.22	28.04	20.61	26.09	20.68
7	Machinery	33.5	41.4	38.8	43.8	16.81	27.61	18.05	28.55	3.21	6.66	2.59	4.61
8	Miscellaneous manufactures	9.9	9.2	9.0	8.5	32.02	29.56	34.76	31.22	26.26	21.17	30.91	29.68
9	Other commodities	0.8	0.9	0.1	0.5	0.11	0.10	0.05	0.01	2.70	1.52	3.45	2.32
MANUFACTURES		74.4	79.8	74.4	79.2	79.38	85.71	81.62	86.86	64.13	54.22	64.95	60.37
TOTAL EXPORT		100.0	100.0	100.0	100.0	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

to the single digit SITC breakdown. It can be seen that, within Spanish and Portuguese exports, the share of manufactures is not only much greater, but it clearly grew in these seven years, while it declined within Greek exports. The share of machinery, and changes in it, clearly displays differences in development and its temporal changes. The share of machinery is highest in Spanish exports, and that significantly grew—from 34 percent in 1988 to 41 percent—in 1995. (The corresponding figures for exports to the EU are even higher: 39 percent and 44 percent respectively.) The share of machinery exports is visibly high for Portugal as well; in Greek exports, however, machinery can be called a negligible item.

In contrast to the growing share of machinery, the share in exports of labour-intensive light industry products and of metallurgy showed a diminishing trend in all three countries (SITC commodity groups 6 and 8), in spite of the continuing large share of clothing and footwear in Greek and Portuguese exports. In Spain, and especially in Greece, their weight is considerable, but their importance within Portuguese exports is much smaller. The share of food products within Spanish exports is, however, diminishing—both within total exports and with respect to exports to the EU countries—while both indices are rising in the case of Greece.

Table 4

Export growth of the South European countries between 1988 and 1995 (percent)

SITC	Commodity groups	Spain		Portugal		Greece*	
		World	EU 15	World	EU 15	World	EU 15
0	Food and live animals	209	225	205	273	195	154
1	Beverages and tobacco	207	257	153	146	173	97
2	Crude materials	148	150	139	131	180	177
3	Mineral fuels	114	90	30	86	343	108
4	Animal and vegetable oils	143	127	322	122	456	529
PRIMARY PRODUCTS		179	192	143	154	221	162
5	Chemicals products	219	254	172	199	188	233
6	Manufactured goods	208	231	198	204	127	114
7	Machinery	280	267	339	341	359	255
8	Miscellaneous manufactures	210	222	190	194	139	138
9	Other commodities	262	930	189	37	97	96
MANUFACTURES		243	252	223	230	146	133
TOTAL EXPORT		226	237	206	216	173	143

*In the case of Greece in 1988 and 1994

Table 4 displays the export dynamism of the South European countries. In this respect too, Spain is in the lead. Spanish exports rose by 126 percent over seven years, exports to the EU even faster, by 137 percent. Portugal is not far behind—there, too, exports to the EU grew faster than total exports. Greek export growth was essentially slower (73 percent); the figure for exports to EU markets even fell below that (43 percent). The differences are even more marked for particular commodity groups. The two Iberian countries were able to boost their exports of manufactures, and particularly of machinery, to a much higher rate than that of total exports, but Greek exports of machinery increased more slowly than average.

Table 5

Trade balances of the South European countries by main commodity groups in 1988 and 1995 (million US dollars)

SITC	Commodity groups	Spain		Portugal		Greece	
		1988	1995	1988	1995	1988	1994
0	Food and live animals	309	−387	−1,286	−2,737	−892	−850
1	Beverages and tobacco	−85	−479	290	255	142	63
2	Crude materials	−3,245	−4,393	−288	−196	−416	−129
3	Mineral fuels	−5,107	−7,669	−1,142	−2,100	−326	−1,098
4	Animal and vegetable oils	505	163	10	−82	16	250
5	Chemicals products	−2,673	−5,872	−1,116	−2,338	−1,214	−2,255
6	Manufactured goods	999	134	−681	−1,252	−1,116	−1,999
7	Machinery	−9,970	−1,694	−5,011	−5,059	−3,418	−5,345
8	Miscellaneous manufactures	−804	−2,535	2,330	3,359	478	−428
9	Other commodities	149	458	7	−155	106	81
TOTAL		−19,923	−22,273	−6,887	−10,305	−6,640	−11,710
Growth of total deficits in percent		100	112	100	151	100	177

Changes in the commodity composition, market allocation and dynamics of foreign trade naturally had a major effect on the trade balances of the three countries. *Table 5* shows that the deficit increased in all three countries; this, however, amounted to only 12 percent (at current prices) in Spain, but to 77 percent in Greece. Portugal, at 51 percent, was placed between the two. The relatively small increase in the Spanish balance of trade deficit was primarily due to the significant, USD 8 billion smaller deficit in the machinery trade balance. Spanish economic progress is highlighted by the fast growth in machinery exports, the reduction of trade-balance deficits in this field, combined with greater deficits in light industry trade balance, where imports grew faster than exports.

The Portuguese trade balance deficit in machinery remained unchanged over seven years but deficits are significantly greater in chemical goods, food products and fuel. The latter were not balanced by a growth in the export surpluses of light industry products. The significant deterioration in the Greek balance of trade is due principally to trade in manufactures, primarily machinery.

To sum up, it can be concluded that just about every aspect of foreign trade exemplifies what was said above about the effects of European integration and the reforms connected with adaptation in Spain and Portugal on the one hand, and Greece on the other. The successes of the two Iberian countries are well reflected in the dynamics of their foreign trade and its structural transformation. Greek failures in this field are clearly due to the resistance shown over a long period to greater openness and to changes demanded by a competitive market.

Some lessons that can be drawn

After surveying the accession to the European integration of the three South European countries and examining its effect on foreign trade, an attempt will be made to sum up concisely what other countries preparing for accession can learn from their experience.

— There are numerous similarities between the economies and societies of the three South European countries at the time of their accession and those of the ECE countries preparing to join. Their economic development was largely of the same standard—i.e. well below that of Western European countries; they were all, for a long time, protected to a large measure against international competition. For this reason, their respective economic structures suffered serious distortions, their production was largely non-competitive, and much of their consumer demand remained unsatisfied. Agriculture was particularly backward, and low skills characteristic of much of the work force hindered the mobility demanded by a changing labour market. All these similarities indicate that what they experienced in the course of integration presents a cautionary tale that should be heeded.

— One should not, however, forget the differences. True, the economies of South Europe were also state-dominated and centralised, but they did escape the road, paved with failure, of the planned economies of the Soviet type. Nationalisation did not cover as large a proportion of the economy; the market, particularly foreign competition, was not excluded with as extreme a protectionism as in the former socialist countries, nor was price-forming by the market, or profit-mindedness, as limited.

— Another similarity is that the South European countries also had to wait a relatively long time before obtaining full membership. At that time the EEC was less prepared for, or experienced, in the admission of less developed countries. As regards the liberalisation of commodity-trade, services and capital flows, or suitability for integration, the ECE countries are already ahead of the South European countries at the time of their accession.

— There is also much similarity in the relative backwardness of the infrastructure. Overcoming this was and will be one of the most important tasks of accession to the EU, something that will only be accomplished relatively slowly and at the cost of great sacrifices. Much support from the EU can be reckoned with; however, all this, and overcoming agricultural backwardness or raising educational standards in the workforce, will require considerable public expenditure. In other words, the duties of the state in these fields will not diminish, but grow. One of the explanations of the Spanish and Portuguese successes is that they were able to increase such expenditure without increasing the budget deficit. This was made possible, at least in part, by discontinuing budgetary support for state firms and banks that were *de facto* bankrupt.

— Foreign direct investments and privatisation had a considerable role in adaptation to the requirements of integration and in the exploitation of the opportunities offered—that is, in the acceleration of economic development. This, on the other hand, in turn depended on how much confidence investors had in economic and political stability. This confidence relied on the success of establishing macroeconomic equilibrium and on the reduction of the state debt, of the budget deficit and of inflation to manageable proportions—i.e. it depended on how determined the government was to implement structural and market-conforming reforms, and to secure public acceptance for unpopular but necessary measures.

— The governments of the three countries were forced to accept, in the course of negotiations, that these were not carried out between equals. It was out of the question for them not to accept the conditions stipulated by the EEC or to amend those conditions. The only thing subject to negotiations was the time and the specific conditions they would be granted for adaptation, what derogations they could get before regulations had to be implemented, and what assistance they might receive for this. An important lesson that had to be learnt by government agencies was to consider very carefully what concessions (and to what degree) they considered essential and in which particular areas. They also had to show determined resistance to unjustified claims by vested interests.

— Unfavourable Greek experience leads to the conclusion that it pays for countries about to join—in their own interest—to make their own economy as thoroughly transparent as possible, even if this slows down the negotiations of accession and makes bargaining more difficult. The weaknesses of less developed economies tend to surface after accession in a tempestuous way, causing great difficulties. Today, the Maastricht criteria offer a better basis, providing orientation concerning the areas and the manner in which an economy must be prepared for membership.

— One should note that it may pay for a particular country to negotiate on its own and not as a group with others. The Brussels authorities are inclined to offer greater resistance to concessions in order to avoid the creation of precedents. The linking up of parallel negotiations with a number of countries tends to hamper and slow down the process of accession.

— The speed and success of accession negotiations largely depends on the determination which a government shows in carrying out the necessary reforms.

That Portugal at first showed a great deal of ambiguity as regards the reasons for accession and adaptation to the integration was no doubt responsible for the whole process being slower and less successful than in Spain. Frequent political changes and government crises generally hinder accession, especially if these lead to frequent replacements of the responsible officials and negotiators.

— The speed of economic adaptation in the South European countries largely depended on the speed with which they were able to abolish the dual structure of the economy within which competitive small and middle-size firms and uncompetitive large state monopolies coexisted. State-corporatist institutions, in which the boundaries between the state and the private sphere were obscured, were most in keeping with this duality. It was kept alive by the politically motivated credit policy of large state-owned banks. Privatisation and free capital flow, as well as the elimination of state interference in the operation of banks, are needed in order to put an end to this duality in the economy, and with it to distortions in the allocation of resources.

— The economic policy of the three countries considerably differed, not only before accession but also afterwards, thus leading to very different results. The conclusion which can be drawn is that, although sovereignty in economic policy is strongly limited by accession, it does not abolish it. Fewer alternative policy courses may be available—nevertheless, they still exist. This situation will predictably continue even after the reforms bringing about the integration within the EU, especially as the introduction of the euro will further narrow the scope of economic, particularly of monetary policy. In other words, when the ECE countries join, the economic responsibilities of their governments will be changed, but they will not diminish.

— What Western policy-makers expected from the accession of the South European countries to the EC were primarily the consolidation of democratic institutions in these countries and the furtherance of their security policy. They did not expect much in terms of economic progress. Yet, with regard to the latter, practice overtook expectations. Significant markets opened up for the industry and agriculture of the developed European countries. Relocating industries in South European countries, and using the opportunities for the export of capital also offered considerable advantages.

— Following accession industrial production was considerably extended and its structure was significantly transformed in those countries which adapted successfully. These changes were largely in keeping with the comparative advantages of the country. Outside factors certainly played a role but most of what was achieved in the way of catching up was due to endogenous changes. In other words, it followed from the transformation of a backward internal economic and institutional structure, from a changed allocation of resources, and from the development of the resources themselves.

— Experience shows that it pays to use the support given by the Community for the designated purposes. The absence of adaptation on the part of Greece was largely due to the fact that the considerable support given was not employed to modernise industrial or agricultural production; only to a limited extent was it used for infrastructural improvement. The support was mainly used to bolster incomes. Such a policy may well be popular in the short run; in the longer run, however, a high price must be paid for it.

— Given an open economic policy which conforms with market demand, a significant trade-creating and growth-accelerating effect can be expected from accession to the European integration. The defence of wrongly interpreted national economic interests (for which read, as a rule, the interests of non-competitive large firms) may well leave numerous advantages offered by integration unexploited (as happened in the case of Greece). This would slow down, or result in the missing of the chances of catching up with the more developed countries.

— EEC membership not only considerably improved the export opportunities of the two countries which adapted well, it also favourably changed the structure of exports. Exports of machinery grew most dynamically. Nor did integration lead to a decline in traditional exports. Such exports also grew considerably but the production and export of new, more up-to-date and sophisticated goods outpaced this growth.

— Many feared a serious decline in the exports of agricultural and food products but this did not occur. On the contrary, in all three countries exports of dairy products, fruit and vegetables increased considerably. Such exports were directed primarily to the countries of the European Union where the market for agricultural products was protected, thus offering better prices and conditions than elsewhere.

— The fear that liberalisation would mean a flooding of backward member states by machinery imported from more developed countries—thus unavoidably bankrupting their engineering industry and machinery exports—proved unfounded. The share of machinery grew considerably in Spanish and Portuguese exports and the balance of trade in machinery improved or, at least, did not decline. Greece, however, could not create a significant engineering industry and the deterioration in the balance of trade was largely due to this fact. It was notable that industrial competition within the Western European integration extended to just about every economic activity and those which proved to be competitive did more than survive: they significantly extended their exports.

— Foreign trade successes were due to the fact that there was an extension of the production of those commodities for which demand grew relatively fast on the world market. Exports were directed to markets where they were competitive or became competitive, and the quality, competitiveness and marketing of these commodities significantly improved. It could also be observed that the beneficial effect of EU accession, working through structural change, was the stronger the higher the tariff barriers of that country had been before accession, and the higher the number of quotas that had acted to restrain trade.

— It was due to the liberalisation and integration policy that, compared with the earlier protectionist period, inter-industry specialisations in trade diminished, and the role of intra-industry trade significantly grew. A similar development can be hoped for in the ECE countries which are about to join. However, this will only be as a result of a longer process which depends equally on changes in the domestic institutional system and the removal of barriers to international co-operation between firms.

— In all three countries, even if accession to the European integration were to enjoy considerable political and popular support, many had doubts concerning the advantages, both before accession and during the protracted negotiations. They believed there would be a certain measure of widening of export markets and they counted on significant transfers from community funds. However, despite the expected advantages, they thought it doubtful that membership would offer considerable further reward compared to those assured by earlier free trade agreements. Would it be worth accepting further import competition in exchange for these, with all the risks and disadvantages entailed? Of course, what had to be borne in mind as well were the considerable long-term disadvantages of staying outside the European integration. Experience has shown that, given a sound economic policy, all these doubts lacked foundation. Advantages deriving from accession and the concurrent modernisation and institutional changes have led to the kind of progress which has exceeded the expectations of most economists. This is perhaps the most important lesson that the European integration of the South European countries teaches us.

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BIRTHDAY GREETINGS TO ANDRÁS BRÓDY

ZS. BEKKER

András Bródy, one of the most outstanding economists of post-war Hungary and a fascinating personality, has recently celebrated his 75th birthday. At almost the same time he received the distinguished title of "doctor honoris causa" from the Budapest University of Economics. At the award ceremony Wassily Leontief, one of his most famous admirers, praised András Bródy as a scholar whose "contribution to our science is no less than the creative and to some extent dialectical combination of Eastern and Western trends in economics". Leontief's comment is a tribute to a career which represents an amalgam of unique individual talents and family heritage, in a special mix with the peculiarities of life in Eastern Europe.

His mother worked as a typographer while his father was the managing director of the Hungária Publishing House. He attended top secondary schools in Budapest between 1934 and 1943. He then studied mathematics and physics at university under the supervision of Lipót Fejér. In June 1944 he was taken to work in a forced labour camp, from where he managed to escape in December 1944. He was able to continue his studies at the University of Szeged. In 1946 he took over the management of the Hungária Publishing House from his father. When the company was nationalised two years later he had to work as a lathe operator in a machine-manufacturing firm by day in order to be able to attend night classes at the Karl Marx University of Economics.

From 1953 he worked as an economist for the Bureau of Metallurgy and Machine Manufacturing, where he prepared plans for production costs based on input-output tables. His co-operation with Ferenc Jánossy, one of the most creative and innovative economists of the period, also began at this time. Over the years their professional collaboration centred on the issues of economic growth and measurement. Their friendship provided inspiration for both of them and it also connected Bródy to the family of György Lukács on intellectual and personal levels. From 1953–55 he worked as chief statistician at the Csepel Pipe Manufacturing Company. His first study about the quality of Hungarian metallurgical products was published in 1954. At around the same time he began to carry out research with Alfred Rényi concerning the mathematical aspects of price reforms and the criteria for their convergence; the results of this work were published in 1956.

At the end of 1955 he became a research fellow at the newly founded Institute of Economics of the Hungarian Academy of Sciences, and to this day he is still associated with the institute. It was from there that he set out to universities and other research institutions around the world for various periods of time as a visiting professor, researcher, journal editor, or as organiser and participant in international conferences. By joining the Institute of Economics the character of his future career was decided: there was no longer a question about where his many-sided talents and interests would take him. He could have become a mathematician, a publisher of art and literature or even an artist but he chose to become an economist. However, in taking this road there was never a question whether his relationship to the establishment might become one of uncritical, passive acceptance.

At the Institute of Economics his research interests centred on mathematical growth theory and on the theory of business cycles. He wrote his thesis on Leontief's input-output theory in 1961. He demonstrated mathematically the uniqueness of Marxian production prices and the average rate of profit; he then established a relation between his findings and Marshall's theorem of long-term equilibrium prices and growth rates. In 1964 he spent a year in Boston, working under the guidance of Leontief at the Harvard Economic Research Project, writing and publishing about business cycles and the equilibrium quantities and proportions of the American economy. Before returning to Hungary he was invited to spend six months at King's College in Cambridge by Sir Richard Stone. He also began to participate in the International Input-Output Conferences together with Professor Anne Carter, first as an organiser, then as a member of the executive committee. He helped to edit and publish conference proceedings and the related volumes. In Hungary, he co-founded *Szigma*, the journal of mathematical economics, with Mária Augusztinovics and Béla Martos.

In 1969 he defended his post-doctoral dissertation. This was titled *Value and Re-production* and it was later publisher in English by the North-Holland Publishing House in Amsterdam. The study demonstrated, for the first time, the mathematical equivalence of the marginalist concept of value and that of the labour theory of value. His findings received wide recognition and this book is still frequently cited, being considered a classic and an important contribution to the science of economics. His next book, *Cycle and regulation (Ciklus és szabályozás)*, was published in 1980, then another, *Slowdown (Lassuló idő)* in 1983. The latter was a Hungarian translation of lectures delivered and published in India in 1982.

Besides doing research, he gradually began to spend more time on teaching. Ironically, he did so mainly abroad, not in Hungary. From 1969 to 1972 he was head of the Department of Economics at the University of Lusaka in Zambia, and was invited to return there and lead the Faculty of Business and Economics between 1974–77. He also lectured at Delhi University in India in 1982, in Nice, France in 1989, at LaTrobe University in Australia in 1991, and at Hitotsubashi in Japan in 1997. Throughout the years he has also been invited to teach at various departments of the Budapest University of Economics. During the past four years he has regularly lectured at the Department of History of Economic Thought both in English and in Hungarian, providing intellectual inspiration for students and faculty members with his presence.

In the nineties, he once again conducted pioneering research work. He explored the economic uses of thermodynamics, he studied the respective theories of measurement in economics and physics and considered the relationship between them, and he published articles about the models of Hamilton and von Neumann. For example, he discovered that Neumann's model is closely related to the concept of the potential function, which is well-known in thermodynamics. Based on this analogy, he introduced the notion of economic entropy, which has raised lively debate among economists and physicists.

The fact that András Bródy is interested in abstract theoretical issues which cross the boundaries of natural and economic sciences does not imply that he is not concerned with current social and economic issues. In fact, he has published journalistic writings since 1987, some of which are collected in two recent volumes: *Ferryland's Millennium (Komporság ezredfordulója, 1994)*, and *Talk to the wall (Falraborsó, 1996)*.

Given his wider social concerns, his active role in professional organisations does not come as a surprise. He was among the organisers of the International Input-Output Society in 1987, and he founded the society's journal, *Economic Systems Research* (Carfax, Abingdon). He served as the journal's editor-in-chief until 1994, and has been a member of the editorial board since then. In 1989 he was elected to be president of the Committee of Economics at the Hungarian Academy of Sciences by the country's most distinguished economists. His appointment was renewed in 1993, and he is still a member of the committee. He also participated in the publication and preparation of the prestigious *New Palgrave* (Macmillan, London) encyclopaedia of economics.

András Bródy is a restless researcher and an individual who has rarely accepted institutional constraints in order to receive "official" recognition. He received the Széchenyi award (the most prestigious award for scientists in Hungary) in 1997 and, as noted above, in 1999 he gained the highest honour conferred by the Budapest University of Economics: the title of "doctor honoris causa".

His professional views and attitude are best summed up by his own words in the introduction to *Slowdown* (Közgazdasági és Jogi Könyvkiadó, 1983): "Even though I deeply respect economic theory and great economists, the reader will find a text here that often reflects opinions, in many ways diametrically opposed to commonly held views. (...) As regards the conclusion of the book that paints a foreboding picture of the future in an almost Cassandra-like prophecy: I myself would be the happiest if I was wrong and we didn't have to face all the difficulties that lie ahead."

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BOOK REVIEWS

MÜLLER, K.: *The political economy of pension reform in Central Eastern Europe.* Cheltenham, UK: Edward Elgar. XIV+222 p.

Introduction

Radical pension reforms have been taking place all around the world. The process started in Chile in 1981, when an ailing public unfunded system was replaced by a private funded system. A second wave of the reform process culminated in 1994 when Argentina introduced a multi-pillar pension system, consisting of a public unfunded pillar and a private funded pillar. Since 1998, countries of East-Central Europe (I prefer this order of adjectives to Müller's "Central-Eastern") have also been part of the reform process. Two countries, Hungary and Poland have already introduced Argentine-type mixed pension systems and other countries (e.g. Slovenia, Croatia) will do the same in the near future. There is only a single country in this relatively developed region, the Czech Republic, which has not followed suit.

What is common and what is different in these reforms? Are they related in any way? What is the reason that some countries have introduced pension reform and others have not? Müller (Research Fellow at the European University Viadrina, Frankfurt/Oder, Germany) has written a very interesting book on these questions and here I shall review her study.

Being a mathematical economist myself, I am interested in the *quantitative* aspects of the Hungarian pension system and its reform. In this respect I can say that I have learned a lot from this study, not only about political economy issues, but also the quantitative aspects. Nevertheless, my different outlook may be evident in this review.

Description

The book contains xiv+222 pages, of which 30 pages comprise references. The book has eight chapters: *Chapters 2* and *3* deal with general issues of pension reforms, while *Chapters 4 to 6* present case studies of Hungary, Poland and the Czech Republic, respectively. *Chapter 1* introduces and *Chapter 8* closes the book. A useful index and lists of figures and tables are attached.

Chapter 2: Reforming old-age security: Design choices and policy blueprints. This chapter introduces basic policy choices, like mandatory vs. voluntary membership, public vs. private management, insurance vs. redistribution, funded vs. unfunded, and defined benefits vs. defined contributions. Although not all combinations are possible, the usual pairing of left and right terms respectively, is definitely an oversimplification.

Although mandatory pension systems appeared more than a hundred years ago, the systems most common today were born around the time of the Second World War. In the bulk of the developed and the ex-socialist countries, the public unfunded system contains significant insurance: there is an earning-related component. Only a minority of countries (e.g. Switzerland, the Netherlands, the UK) have mixed systems—moreover, their public unfunded pillars are totally redistributive: i.e. they are flat.

As was mentioned in the introduction, Chile was the first country which replaced its public unfunded system with a private funded system, and a couple of other Latin American countries followed its example in the 1990s. The influential study of the World Bank (1994) set the agenda with its emphasis on multi-pillar systems. For the remainder of this analysis, it is useful to simplify the World Bank's recipe as follows: a modest first pillar with an unfunded public pension, guaranteeing the same (flat) benefit to everybody; and a strong second pillar with a funded private pension, providing (according to a defined contribution) to the contributors. Müller succinctly calls this approach the *new pension orthodoxy*.

Although most economists have accepted these ideas, there is a significant number of experts who have expressed their doubts; some have even opposed these blueprints. (No lesser person than Joseph E. Stiglitz, the then Chief Economist and Vice President of the World Bank, wrote against the "Ten Myths of Social Security" in September 1999. He no longer occupies these posts.) These experts have tried to defend and modernize unfunded public systems and prevent their assumed degradation into meagre social assistance.

Chapter 3: Approaching the political economy of the pension reform. Until now the conventional wisdom has been that, notwithstanding its unattractive features (e.g. decreasing returns caused by aging, slowing down, maturation and tax evasion), political constraints do not allow the replacement of an unfunded system by a funded one. Economists also have many interesting models on this topic as well, but they have not been very successful in explaining developments in the past or recently.

Our author has applied the "actor-centred institutionalism" (developed by Renate Mayntz and Fritz Scharpf) as her basic explanatory framework for discussing the pension reforms and their directions. This is a synthesis between the structuralist-institutionalist and the actor-centred approaches. In this study it can be specified as follows: "structural and institutional factors condition largely which actors become involved in the process of the pension reform, as well as their relative strength. Given the actors' respective cognitive maps ... and their consequent perception of pension reform alternatives, the constellation of relevant actors defines the basic paradigmatic outcome" (p. 52).

Political economists have come up with the idea of *benefit of crises:* and old system has to break down to yield to a reform. This seems to have happened in East-Central Europe.

On a general level, the transition from socialism to capitalism eliminated the old deal between the communist party and the population of the East-Central European countries. The emergence of a market economy coincided with a deep depression which created mass unemployment, a hidden economy, and massive early retirement. At the same time, the necessary price reforms and the reformed fiscal systems resulted in serious inflation. These changes have seriously deteriorated the balance between the revenues and expenditures of the public pension system.

Putting it in simple terms, one may say that it is the Ministry of Finance that has led the fight for pension reform and the Ministry of Welfare has tried to save the old deal. The external help of the World Bank may be important in the case of highly indebted countries like Hungary and Poland, but may be insignificant in other cases such as the Czech Republic.

I have no space to go through the three case studies. I want to assure the reader that they are excellent, and go much beyond a mechanical application of the abstract theory of political economy. Even experts working in the field can learn a lot from these clever descriptions and analyses.

For a reader who is not well-informed on the issue, here I only mention the basic features of the Hungarian pension reform.

On January 1, 1998 a new, three-pillar pension system was introduced in Hungary. It will replace about 1/4 of the existing unfunded public system by a funded private system from 2013. This transition is obligatory for people who entered the labour market after June 30, 1998 and optional for others. Meanwhile the public pillar is also being reformed: the pensionable age is to be smoothly increased to 62 years for both women and men by 2009, while inter-cohort redistribution is to be eliminated by 2013. By September 1999 about half the working force will have entered the mixed system.

Here we turn to *Chapter 7: Central-Eastern European pension reform in a comparative perspective*. There are three similar countries which had a similar history and development before 1989 in general, and concerning their respective pension systems in particular. Ten years later two of them, Hungary and Poland, introduced mixed social security systems, while the Czech Republic still has not done so. As in the natural sciences, we have a possibility to verify a theory and Katharina Müller was fortunate: her explanation seems to be good. (Repeating what has been said before, the Czech Republic was not pressed by external and internal deficits to radically reform its otherwise balanced pension system, and its leaders have not embarked on this reform.)

Chapter 8: Conclusion... Müller has arrived at the following conclusions. (i) The decision on pension reform cannot be simplified to a cost-benefit analysis—i.e. it is not simply an "economic matter", politics also being involved. (ii) The actor-centred institutionalism has been able to explain the possibility of radical pension reforms. (iii) "Benefit of crisis" was more important than "path dependence" in determining the fate of the pension reforms in East-Central Europe. (iv) "Tactical sequencing, strategic (un)bundling and packaging" have been important. (v) "...(F)undamental pension reform was purposely—and successfully—pursued in a pre-electoral period." (vi) "...(I)t is expedient to stress that any kind of old-age security reform is but an intermediate stage in an on-going process."

Evaluation

I have already made several favourable comments on Müller's book. Here I only summarize them. This book deals with an important topic, its analysis is reliable, and it obtains interesting results. Müller combines politology and economic theory with empirical data and observations. She has spent a good deal of time studying these countries and their institutions and she has interviewed a lot of experts. Furthermore, the book is very well-written and thus it is a pleasure to read.

Before finishing my review, let me make several critical remarks.

a) Although Müller does not believe in the new pension orthodoxy, and she has mentioned some potential problems with the partial privatization of pension systems in Section 2.3; she does not repeat her fears on the possible adverse effects of the reforms later, in the East-European context. (What happens if the cost of transition is much higher than forecast and the added burden depresses a couple of cohorts?)

b) Müller argues (p. 28) that World Bank and Finance Ministry experts may not be satisfied with the relatively modest reforms and may press for further reforms in the future, making the presently subordinated second pillar the dominant one. While I share some of her fears (i.e. replacing the newly introduced mixed wage-price indexation with a pure price indexation), at present I cannot imagine a "permanent revolution". I do hope that these experts have also learned from past experiences and will learn from the new ones. Furthermore, any serious change in the respective weights of the two pillars would open a Pandora's box and lead to constitutional problems.

c) Müller underlines the low quality of, and contradictions in statistics in the case-study countries but, nevertheless, she also quotes some inconsistent data. Let me mention a few instances.

Line 4 in *Table 7.1* gives surprising numbers on monthly pension benefits, respectively: Hungary (1997): USD 107, Poland (1998) USD 240. The other lines of the same table show relatively small differences between the corresponding replacement rates (56.7 vs. 72.5 percent) or system dependency ratios (83.9 vs. 61.2 percent); these imply that Poland is much richer than Hungary although this is not the case. A similar problem appears with *Table 7.6*. From 1994 to 1995 the stock of Czech external debt in USD increased by 61 percent, while its relation to exports rose only 4.7 percent. Does this mean that Czech exports increased by 53.7 percent in a single year? Of course, the author is not responsible for these errors but it would have been wise to signal the discrepancies.

To sum up, Müller's book has to be read by anybody who is interested in pension systems and pension reforms, and especially in the ex-socialist settings.

A. SIMONOVITS

WHEELOCK, J.—MARIUSSEN, A. (eds): *Household, work, economic change: A comparative institutional perspective*. Boston/Dordrecht/London: Kluwer Academic Publisher. 1997. 238 p.

Institutional analysis is very much in fashion nowadays. Some years ago the Nobel prize was given to an economic historian (North) who wrote some excellent treatises on various themes in economics and economic history using the institutional approach. The boundary between economics and sociology is questioned by successful institutional analyses like the comparative organisational analysis of markets and hierarchies (Williamson) or the transaction cost analysis of Pollack or Ben-Porath of "traditional" sociological institutions such as friendship and the household. The book in question is an attempt to use the institutional approach to analyse the labour market and the household.

To summarise the main features of the book, this is an experiment to compare the deteriorating local labour markets of Britain and Norway and it uses anthropological-type case studies to show the similarities and differences of the forms households employ to cope with bad and worsening conditions. There seem to be two problems with the book. First, I do not accept their theoretical position (which comes across as a curious sort of anti-institutional-economics institutionalism); secondly, though case study type empirical analysis can be very useful for raising new issues and describing the details of processes, in this particular instance there are almost no new elements illustrated by the case studies. In fact, they serve more as examples for a would-be-research project rather than being convincing analyses of the processes.

However, the book fits very well into my thesis of the coming of the new wave of the "eternal" renaissance of the household. The editors argue (following *Dahrendorf* 1995) that in Europe there is and will be (perhaps on an increasing scale) an antagonism between social solidarity and economic competitiveness. They foresee (and have already experienced) that households will be considered as the "natural" units for increasing the flexibility of the economy. In other words, the household will be (or is already) rediscovered by the New Right as the panacea of economic problems without endangering solidarity since the household, by definition, is eternal and its capacity to survive is limitless. This of course will prompt counter arguments. And the result may be a new wave of theories on the "eternal" renaissance of the household as an economic actor.

In the following I start by introducing the book briefly and then summarize what I consider to be its main shortcomings. I then go on to argue why I consider that, despite the problems, it is an important contribution to professional literature which deals with the household.

On the book and its shortcomings

The structure of the book is rather complex and slightly confusing. Altogether there are 13 chapters preceded by one foreword and one introduction and followed by a concluding chapter. The thirteen chapters are split into three parts: a theoretical one, a locality-oriented one, and a long one which contains three sections. These sections focus on three relevant empirical issues and contain case studies. To make things more complex, all the three parts and the three chapters have their own "mini-introductions". It is no surprise that there are several questions which are raised in almost identical forms in various parts of the book, and several answers are given with almost the same words to the similar questions.

Anti-institutionalist institutionalism

In the second paragraph of the *Foreword* the authors declare their institutionalist focus: "The comparative approach taken in the book is amenable to the application of institutional theory, which here is used to analyse work. Institutional theory is interdisciplinary..." (p. xv). Then, in the second part of the *Foreword*, they write that: "To open this book, we have to use institutional theory, to see how distinctions between public and private, society and household, market and non-market (sic!), work and family life, are constructed and reconstructed..." (p. xix).

Both the bibliography, the content of the *Introduction*, and *Chapters 1* and *2* prove that they took their task seriously and tried their best to cover and discover the various institutional approaches and apply them to describe the coping-adapting strategies of households in a rapidly changing and often hostile environment. The problem is that, given the way they use the institutional approach, they omit all the advantages of this theory; thus what remains of it is nothing more than a meaningless sequence of references to the "human side" of the labour market, the specificity of the household as an economic actor, and the complexity of the domestic decision-making process. These are all well-known facts and could have been properly analysed by using the institutional approach.

Nevertheless, the authors did not use this approach. One can only assume that they did not understand it, for if they had they would not have written such words as the following: "In order to study institutions as they are created and transformed, the appropriate method is not to cover a few variables in a large number of cases... but rather to analyse interconnections between several variables through time, in a limited number of cases." (p. 2) This seems to suggest that institutional theory has something to say on the nature of empirical work. Or: "Within economics, institutional economics pays attention to the political dimensions of economic behaviour..." (p. 5). Later in *Chapter 1* they give a comprehensive overview of institutional sociology and economics. The *Figure* they provide (p. 15) is rather complex and in my view absolutely false (for example, institutional economics is regarded as a dead-end street, and new institutional economics is not related to the institutional approach in sociology). But what is more important is the result of their analysis.

The result of their analysis is a mixture of the obvious and the naïve. Who would not agree, for example, with their claims that the institutional approach is a good way to uncover the power basis of social actions, to "focus on cultural processes and the social construction of knowledge" (p. 6), and to "examine the processes of evolutionary change" (p. 6)? The question is: how can these goals be achieved? Their suggestions—i.e. to see the economy as an entity and to see the household as the centre of all economic action—are partly obvious, partly naive but they definitely do not prove the usefulness of the institutional approach.

In opposition to the opinion of the editors of the volume I consider the new institutional economics in household sociology to represent seminal approaches because they:

— offer useful suggestions about how to analyse the behaviour of the household "embedded" into concrete economic-social circumstances and this helps us to understand the unique characteristics of the household which explain its "eternity",

— compare households with other institutions and this gives the reader the possibility to see the institutional characteristics of the household in the light of alternative institutional solutions.

The two classics on the subject are *Ben-Porath* (1980, 1982) and *Pollack* (1985). The first "discovers" the importance of "identity" in economics, while the latter applies the transaction cost approach to the households.

The Ben-Porath article from 1980 begins with the development of a continuum within which the family and the textbook markets are the extremes. The former is the "maximum-identity" institution in which the transactions are repeated games involving "dealings with each other". This serves as the focal point for "implicit contracts" while the latter is characterised by spot market features, anonymous actors and frictionless transactions. On this continuum several types of identity can be arranged and these various "levels of identity" create entirely different cost and benefit conditions in the course of transactions: "The degree to which identity dominates or is subsumed under the impersonal dimensions of specialisation shapes the type of transaction and contract." (ibid. p. 1).

From this very simple idea he develops three "worlds" which differ from each other in the importance of identity and as a consequence have different agents. The same agents have different patterns of organisation, different risks and different solutions to cope with. They differ as far as the cost of their respective operations are concerned and the ways they try to reduce these costs.

In a later opus Ben-Porath (and some of his followers) "rediscover" the household as the core actor of income production and distribution: "... the family, however, is not merely a statistical nuisance that must somehow be suppressed in the analysis of income distribution. Families are the major non-market institutions through which incomes are jointly generated, pooled, and redistributed." (Ben-Porath 1982, p. 1)

With regard to income generation, the central point of new home economics is that it assumes that "gains from intrafamily transaction beyond what each could produce on his own in the market or at home rest on the gains from the division of the labour in the household and between the household and the market and from the advantages of co-operation. Co-operation between family members is advantageous partly because of the superiority of transactions between partners tied in a long-term relationship embedded in the family... This encompasses not only the allocation of labour time between home production and the market, but transactions in capital, the joint management of property, mutual insurance and help, and so on... The gains from the family connection are likely to be larger (at least for large families) the less developed are the markets for labour, capital and insurance and less active the government in providing substitute services..." (Ben-Porath 1982, p. 2)

As to pooling and sorting, the basic question is: what are the borders of the household and what type and volume of pooling, sharing of income and wealth and what forms of sorting of potential household members occur within and through these borders? As one article of the volume demonstrates, the income distribution might be very different depending on the way one defines the border of the household [Western type nuclear family versus the Chinese extended family form (the chia).] (*Greenhalgh* 1982)

Pollack (1985) begins his seminal article with an argument that fits perfectly into my "eternal renaissance" thesis: "Families are fashionable. Within the last decade, social scientists have rediscovered families and households as fit subjects for serious analysis." (ibid. p. 581).

The theoretical benefits he expects to gain from using the transaction cost approach in analysing the operation of households stems from the fact that this approach keeps from the new home economics some elements of standard economics (such as cost-benefit analysis, production functions) and acceptable axioms (i.e. relevance of preferences, the concept of optimalisation). However, it extends the scope of analysis to the structural and organisational aspects of the household as an institution.

In the essay the author compares the family and the market as units of production and his suggestion is an extension of the "identity-argument" of Ben-Porath: "The advantages of the family as a governance structure for organising particular activities flows from its ability to integrate those activities with pre-existing, ongoing significant personal relationships." (ibid. p. 585) His examples prove this thesis in the cases of home production, consumption, insurance and production for the market as well. Furthermore—as is supposed from a comprehensive model—he argues that it is exactly the same structural characteristics of the household which give them the competitive edge in certain situations and which are the major causes of their disadvantages in other situations.

What does *Chapter 2* offer us as a result of the overview and "development" of the institutional approach? The result is a so called "cloverleaf model" which describes the household as the centre of the state and the market and the non-market production. This model is, however, partly redundant since it says nothing new if it is compared to the various pieces of Pahl and Gershuny (see below and also references); moreover, it is partly superficial since it only illustrates the obvious (state, market and households are interconnected, the household is present in all three segments of the economy, etc.) and, as a consequence, does not help the authors to make any kind of proper and detailed analysis.

The limits of the case study technique

To describe new phenomena, to analyse intertwining long-term processes, to uncover hidden meanings and messages I consider case study-based analysis more useful than a survey dataset. The authors aim with this volume, using a comparative approach, was:

— to show the emerging trend of "coping" behaviour on labour markets,

— to show the way the labour markets interact with changes in state regulation, domestic structures and identity management.

Given the above, I absolutely understood their decision to rely on case studies. However, such case studies—having no statistical foundations—should consist of much more than simple descriptive material to convince the reader that the trends they describe are relevant. The processes shown should be detailed and should cover relevant aspects of the intertwined and overlapping influences to make the point. What is more, the illustrations of the hidden messages and the changes of the identities should be lucid in order to make clear what their underlying meanings are. As I will show in the following—by briefly summarising the case studies given in *Chapter 3*—only two of the eight case studies meet these expectations.

Part Two contains three chapters and these characterise the local labour market developments in the course of economic restructuring in Britain and in Norway respectively. The focus is on the local level and on the system of specific regulations. The main conclusions can be read in the titles: the British restructuring being "market-led" while the Norwegian a "corporatist" form of economic restructuring. Following the two local case studies the third chapter of this part offers a comparison between the British and the Norwegian cases. These chapters help the reader to familiarise themselves with the context of the case studies as they are presented in the following chapters and to interconnect the macrolevel, regulation-oriented level of the analysis with the microlevel. This is important, partly due to the fact that this interaction will be the ultimate target of the New Right restructuring policy critique and also since this is the annex on which the state production is related to the local levels of market and domestic production—i.e. this is the third piece of the cloverleaf model (which itself, however, neglects the vertical axis).

The three sections of *Part Three* comprise the central part of the volume since these case studies are supposed to offer the ammunition for the institutional analysis. These chapters cover the following issues: household responses to the changing employment patterns of local firms and to unemployment, the old-new patterns of domestic production, and the special features of the labour market behaviour of the youth. As can be learnt from the concluding chapter, the former is supposed to give us an overview of the reactions existing households have, the latter of the reactions of would-be-households in coping with the changes of the employment conditions on the labour market, while the section inbetween focuses on domestic production.

Section A, Chapter 6 raises the classic question. How does the social division of labour change in the course of economic restructuring? This chapter does not rely on individual case studies but gives a general picture of the rather tensionless path of the restructuring of a Norwegian local labour market. *Chapter 7* repeats the previous question but it deals with a British locality and has a special focus on male unemployment. Here we find one case study but the emphasis is on a small sample of households in which the male breadwinner has lost his job. The "shocking" result of the analysis was that in 47 percent of the 30 cases there were some changes in the division of labour... *Chapter 8* describes the changing and unchanging practices of the employed in the face of the disappearance of regular full-time jobs and the way they coped with the emergence of a semi-casual, semi-short term contract based employment system. This analysis is based on case studies and there are some lively examples. The brief quotations are not only illustrations of an already well-known trend but provide insights to a new process. The interesting finding in this chapter is that those young employees who try to follow the labour market behaviour of their ancestors (with its emphasis on loyalty and servility towards the employer) will be losers while there are three types of reflexive and flexible alternative routes: i.e. constant retraining, self-employment and adaptation to a casual job-based new environment.

In *Section B, Chapter 9* raises the division of labour issue again but in a different context—i.e. in a household coping with technological development and dealing with small scale agricultural production. The summary of the 25 case studies shows that the previously labour-intensive farm work, which needed the continuous co-operation of husband and wife, is now a "one-*man*-show" (italics from the original text p. 143). As a consequence, women have moved out from agricultural work either to state-financed jobs or towards more feminized household chores. *Chapter 10* uses (rather arbitrarily in my view) environmental consciousness as a proxy for traditionality and modernity and shows (rather unconvincingly) the process of the intergenerational succession of the agricultural families and the way this is influenced by the difference of attitudes towards the environment. *Chapter 11* is again a short piece on a classic issue—i.e. the flexibility of a small family business as a coping means for survival. The case the author refers to shows quite convincingly the unsurprising fact that family-based mini-enterprises are often not the first phase of a developing small firm but only a temporary and self-exploitative survival solution for those who are worse off.

Finally, *Section C, Chapter 12* is a case study of changing youth identity as a response to the diminishing chances of retaining the inherited full-time work-oriented value system. The proper combination of data and case studies offers a convincing argument that, under certain circumstances (and very likely not only in Newcastle), a new value system will be the result of the "high level unemployment, low pay and poor career prospects" (p. 184) on the labour market. It is possible that football hooliganism is a by-product of this search for a new identity? Finally, *Chapter 13* shows the gender-based differences in having a career in a changing economy where there are more (but not necessarily good) opportunities for "modern-flexible" females and less and less for "traditional-outdated" males.

On the "eternal" renaissance of the household

The concept of the "eternal" renaissance of the household as an economic actor refers to the following twin-assumptions:

— the household as an economic actor is "eternal" (*Braudel* 1979) but in "normal" times it is invisible for mainstream social research; this is because it is "natural" and/or hidden-disguised and/or "theoryless" (compared to other major actors such as the state or market),

— from time to time, due to various reasons, scholars keep rediscovering the household as an economic actor. (The reasons include the swing of the pendulum of the thematic discourse of social sciences or, alternatively, the development of the theory, the political articulation of institutional changes in the economy, and the ad hoc societal issues which infiltrate scholarly debates from the media, etc.)

Since the early 1970s the household as an economic actor has been made visible (again) and it has been (re)discovered in various forms, such as:

— totally "theoryless", as one of the alternatives in coping with crisis (*Caplowitz* 1979),

— a low cost (being "natural") resource (*Boulding* 1972),

— the owner of huge amounts of the national wealth (*Burns* 1975),

— the result of the "natural" flexibility of the household as a production unit of labour which has survived industrialisation (*Minge-Kalman* 1978),

— an efficient production structure (*Becker* 1965),

— a product of the commodification and extension of the world market (*Friedmann* 1978).

Based on the preceding "discoveries", there was a revival of the household as an economic actor in the early 1980s in Britain (see the references of *Gershuny* and *Pahl*). The culmination of this revival was the Gershuny-Pahl triangle. This model emphasised the negation of the linearity of the evolutionary process and the authors claimed that there was no "single great transformation" from a custom-based towards a modern economy. "Rather, we argue that technical innovation, changes in the capital endowments and modifications in legal institutions and in patterns of organisation combine to produce a rather less tidy pattern of development. Instead of the steady one-way flow of economic activity from the household to the industrial production system, we see a whole series of little transformations of production... whose directions are determined by the particular social and technical conditions relating to the production of particular commodities and particular times." (*Gershuny and Pahl* 1981, p. 79)

This revival of the household went hand in hand with various other "discoveries" such as the informal economy (*Henry* 1978, 1981, Gershuny 1979, *Mars* 1982, *Pahl* 1984), ethnic and local economies (*Wallman* 1979, *Ethnic...* 1984), self—employment, simple commodity production, and small scale production—linked with the "sweatshop concept" (*Family...* 1984). This might indicate that, with the renaissance of the household issue, there might also have been the "discovery" of something deeper and more complex than merely swing of the pendulum of sociological discourse.

In my view, the main theoretical innovation in the volume—the so-called "cloverleaf model"—does not add anything to the Gershuny-Pahl triangle model and the case studies in the volume give only a very superficial illustration of current trends. However, the conclusion of the volume gives very convincing arguments against the New Right position; the latter assumes that the household sector would solve spontaneously all the social problems of economic restructuring and the "casualization" of the labour market.

This debate might be the beginning of a new "upwave" period of the household renaissance phenomenon in Europe.

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E. SÍK

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*We acknowledge the receipt of the enlisted books. No obligation to review them is involved.

Out of technical reasons I. R. Gábor could not check the final English version of his study entitled "Post-Socialist Transformation and the Labour Market in Hungary—the Quest for Institutional Realignments" and that of his book review on J. Varga's book, entitled "The Economics of Education" in the previous issue of Acta Oeconomica (Vol. 50, Nos 1–2). Both the author and the readers have the editor's apologies.

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András NAGY, see Vol. 49, Nos 3–4.

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