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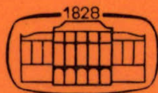

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IMPORT LIBERALIZATION IN HUNGARY

A. NAGY

In the following the Hungarian import liberalization experience is analyzed, and within this special attention is paid to the timing and sequencing of liberalization, to the social forces supporting and resisting the introduction of liberalization measures, and to the social consequences of structural change. The research concentrates on the institutional aspects of the trade liberalization process: how the existing (inherited, reformed and newly created) institutional structure and its interests and conflicts have affected the elaboration, acceptance and introduction of the liberalization measures, and how they have influenced the consequences, the modifications and development of the regulations.

The import regime before liberalization

In Hungary the import regime of the strict command economy changed significantly with the reform of the economic management system in 1968. It was evident for the radical reformers of the time (see e.g. *Nagy* 1967) that the introduction of competition was one of the fundamental conditions needed to increase efficiency. This could not be realized if the economy remained monopolized and closed. One of the great successes of the idea of import liberalization and practical convertibility could be found in the resolution on the reform, made by the Central Committee of the Hungarian Socialist Workers' Party; this resolution included the principle that "the enterprises which have forints[1] can import". The idea was that planned import quotas would be abolished so that companies requiring imports could apply for and automatically receive import licences, and they would be allowed to change forints into convertible currency for this purpose. However, it soon turned out that including such principles in resolutions was not nearly enough to realize these aims.

Even if the Hungarian economic reforms of 1968 in many respects proved to be successful and economic activities—including imports—became freer and more efficient, it failed within a few years. Trade was not liberalized and in practice only the system of control and management of trade was changed.

The managers of the big state-owned firms supported the reforms inasmuch as it liberated them from many restrictions of the command economy and enabled them to become more independent and powerful. This also meant that they even

The support of the Institutional Reform and the Informal Sector (IRIS) at the University of Maryland and the Hungarian National Scientific Research Foundation (OTKA) is gratefully acknowledged.

[1] The forint is the domestic currency in Hungary.

MAGYAR
TUDOMÁNYOS AKADÉMIA
KÖNYVTÁRA

wanted to get rid of the weak pressure for efficiency—emanating from the planning system. Many ideas of the reforms—such as a competitive market-economy, increased efficiency pressure, opening to the world economy—were frightening to the conservative managers, for such tendencies hurt their interests. At the same time, the elimination of the mandatory plan-targets by the reforms strengthened their positions and reduced the power of the central authorities.[2]

The system of protectionist import regulation that was developed in the early seventies was not so much exercised by tariffs, or explicit quotas, but by complex and informal methods of import rationing. These were kept strictly secret and were aptly called by *Gács* (1986) "a regulation based on consensus". The "consensus" was reached in a bargaining process between the "user" enterprises of imports and the monopolist trading companies. In this process both partners were interested in maintaining cordial relations and, as a consequence, importers showed considerable self-restraint in their import requirements. This import control system used the "base-year" principle, meaning that the level of licensed imports was determined by the previous year's imports. In order to acquire a higher volume of imports, a difficult bargaining process was necessary, where applicants had to show what losses would be created by the lack of higher imports in national economic priorities.

This complicated system was developed mainly because one of the major aims of the Hungarian government at the time was to convince international organizations and the main western trading partners that the economic reforms had created a market economy in Hungary and the foreign trade regime in particular was similar to those of the developed countries, i.e. it was liberalized. They especially wanted to get rid of the disadvantageous "state trading" status, in order to show the international community that Hungarian firms were autonomous in their decision-making. The international community let itself be misled, and accepted the picture offered by the Hungarian government, which was much more attractive than the reality. (*Oblath* 1991b, p. 209; Nagy 1991, p. 224) Hungary became a member of the GATT, and later a member of the IMF and the World Bank. These institutions seemingly accepted that there were no import restrictions in Hungary, except those connected with tariffs and quotas for consumer goods and some basic raw materials.

The regular increase of imports could be financed in the seventies, partly because import demand was strongly restricted or suppressed, and partly because there was no strong opposition to the growing import surplus, i.e. to increasing indebtedness. This did not mean that the shortage of convertible currencies diminished: with more contacts with the developed economies, there was an increase in the unsatisfied demand of the enterprises for modernization, and of the consumers for better quality goods. It was a generally accepted view that centralized foreign

[2] *Szalai* (1989) provides a vivid insight of the struggles for power between the managers of the big firms and the bureaucrats of the central authorities after the introduction of the reforms.

exchange control was needed because of the shortage of convertible currencies. In fact the relationship was the reverse:

"It is not shortage that generates centralized foreign exchange control, but on the contrary, it is the central administrative decision making and management (centralized foreign exchange control included) that generates shortage—in particular, the shortage of foreign currency, and the tendency of growing debt."[3]

In 1982, after the military coup in Poland a serious balance of payments crisis threatened Hungary, creating a turning point in the import licensing system. Drastic measures were introduced; at the time these measures were referred to as "hand-steering". Import licensing was tightened for a time and licences were issued by a vice-premier item-by-item. Even when the import licences were granted, the actual foreign exchange transfers were in many cases delayed by the Hungarian National Bank, for these depended on its liquidity conditions. This acute shortage situation revealed that the central authorities had no intention of using financial methods to reach a new equilibrium, e.g. by exchange rate devaluation. They thought they "knew better"—i.e. which import items were needed, and which were not. In fact, of course, they could not know what should be imported, and which was the right choice from among several alternatives. They could only rely on the "basis" of the foregoing period, allowing—arbitrarily—more or less imports to the applicants. Thus a bargaining process was created, where relative power relations, or the "good connections" of various interest groups had more weight than any central preference or rationality. (Gács 1986; *Pásztor* 1988) As import licensing became tighter and arbitrary, it gave rise to "hoarding", i.e. an unreasonable swelling of demand. This showed that, by making the controls stricter, the chronic foreign exchange shortage was not alleviated but maintained and reproduced.

The hypocrisy of the Hungarian government increased and they did everything to hide the way in which the import regime really worked. For example, a police investigation was started against research workers for "divulging state secrets" by publishing, or intending to publish articles revealing the actual working of the import licensing system.

It should be noted that the resistance to a return to mandatory planning methods and to a less liberal trade policy did not come from the international organizations, like GATT, or IMF, but from the great firms. The latter wanted to defend the independence and autonomy they had previously achieved. They reacted strongly to the fact that the "hand-steering" method of import licensing significantly increased the uncertainty of getting the necessary import inputs in time. With the strong central intervention in "their affairs", the consensus between the managers and the bureaucracy disappeared and the struggle between them for power and authority became more fierce. The demand for import liberalization came first from the dissatisfied managers of some big enterprises; however,

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[3]For more detail see: Nagy 1989, pp. 385–386.

for them it only meant the removal of constraints on importing the necessary materials, parts and equipment. They argued that without the freedom to import, they would be unable to compete on their export markets. Brought up in a nearly perfect protectionist environment, very few of these big enterprises were afraid that liberalized imports may endanger—through competition—their own products on the domestic market. It was not surprising that when in 1988 they understood that the government was preparing the introduction of a more general import liberalization policy (including not only materials and parts, but finished industrial products too) their professional organization, the Chamber of Economy, issued a declaration stating that they could agree to it only as a "long-term perspective".[4]

The preparation of import liberalization had already started in the mid-eighties in Hungary. In 1985 the Ministry of Foreign Trade commissioned a research report from the Foreign Trade Research Institute (KOPINT) concerning the feasibility of a gradual liberalization of imports. In addition the Hungarian National Bank started to investigate the experiences of other countries where import liberalization was linked to convertibility and the introduction of foreign exchange markets. From 1986 onwards more and more articles were published in the professional journals on the experiences and consequences of import liberalization and the introduction of convertibility. In these reports there were many hidden innuendos regarding the necessity to further the Hungarian economic reforms in these directions. (Nagy 1986; *Breitner* 1987; *Sipos and Urban* 1987; *Horváth* 1987)

The first elaborated proposal for import liberalization was produced by Gács (1986). This intended to start a gradual process by using two extreme cases from a competitiveness list prepared by the Ministry of Industry: i.e. the case of hopelessly uncompetitive products, and those products which could face import competition. The idea was that this would enhance specialization at both ends, resulting in the increased efficiency of the economy. According to the proposal the timing of the liberalization was to be announced in time for the enterprises to be prepared for the competition. However, this proposal was apparently strongly opposed both by the administration and by the managers of influential large state enterprises.

The process of trade liberalization in Hungary

When in the summer of 1988 representatives of the International Monetary Fund informed the Hungarian government that the liberalization of imports should not to be delayed any longer, preparations by the administration started in earnest. The Ministry of Trade rejected the proposal of Gács, mainly because the suggested introduction of strict normative rules in the selection of the gradual liberaliza-

[4] Cited by Pásztor (1993 p. 66).

tion process contradicted not only the interests of the firms concerned, but the protectionist stand of the administration. Also, it would have reduced the administration's direct influence on decisions concerning what and when to liberalize.

It has been mentioned above that the demand for import liberalization came first from some of the great firms that demanded the removal of the central controls on their imports of materials, parts and equipment. In this light it can be regarded as their success that in the first year it was mainly the import of investment goods, and in the second year that of material inputs for production purposes that were liberalized. It was only in the third year, i.e. in 1991, that a significant portion of finished industrial products had to face import competition.

There was a strong resistance to sudden import liberalization in different branches of the administration, especially in the Planning Office. While originally the Ministry of Trade proposed a 70 percent liberalization for 1989, the Planning Office affirmed that the planned balance of trade surplus could only be achieved if liberalization did not exceed 30 percent. They added that in the case of more than 40 percent liberalization "the government would have to a face an incalculable trade deficit".[5] At a time when one of the main concerns of the government was the way to cover the heavy debt servicing burden, the scaring of the authorities with an "incalculable" trade deficit obviously served only to deter them from liberalizing trade.

There were two reasons why the resistance of the Planning Commission to liberalization was defeated. On the one hand, the Hungarian government would have had to acknowledge that what it had asserted at the time when Hungary was admitted to the GATT had not been true, i.e. the official statement that imports had been liberalized and—except for a few quotas—there were no other obstacles to imports than tariffs was false. Moreover, the GATT and the IMF would have had to admit also that they had let themselves to be misled and had not recognized at the time that the Hungarian government's statement was untrue. The substitution of quantitative restrictions with tariff increases—as advised by trade experts—would only be acceptable if the existence of quantitative restrictions on the commodities concerned were acknowledged.

The other reason was that in the closing phase of the communist regime a group of radical reform economists got the upper hand within the administration. They wanted to demonstrate their seriousness and resolve to introduce fundamental changes in creating a market economy by proclaiming that only the fast opening of the economy could make the Hungarian enterprises efficient and competitive. One should not forget that in this short-lived "perestroika" period the reformists hoped to save the communist system and their own rule by a limited and "well-controlled democratization" and opening.

[5] Quoted by Pásztor (1993 p. 70) from the minutes of the Planning Commission.

At the end of 1988 it was evident that the Planning Office and the Ministry of Trade could not continue to licence in detail all imports; what remained to them was the elaboration of the lists of products to be liberalized and the decision on when this should happen. Their perspective was rather short-sighted, for they intended to delay the shock of liberalization in the first year by including in the list of liberalized products those which were always exclusively or largely imported. Since the beginning of import liberalization to restrain import demands, importers have been obliged to provide forward forint cover for each import transaction in a blocked bank account without receiving interest. (GATT 1991, Vol. I. p. 8)

The import liberalization programme in Hungary was in fact implemented faster than originally planned. In the original proposal of the government, accepted in 1988, imports accounted in convertible currencies were planned to be liberalized over the course of four years: between 1989 and 1992, in 20–35 percent increments. Due to the prevailing democratic and liberal political forces, to the pressure of the IMF and the World Bank and to the favourable experiences of the first period, the process was speeded up and finished in three years. By the beginning of 1992 about 90 percent of imports were liberalized, and about 70 percent of production had to face import competition. However, food products and consumer goods remained largely restricted. As most of the trade with the former Soviet-block countries was also accounted in convertible currencies, the same treatment and liberalization measures were extended to practically all imports.

The expected advantages of trade liberalization were numerous: it was believed that it would abolish, or at least diminish, the distortions of the incentives, prices and investment motivations; import competition and the free inflow of foreign capital would create a competitive domestic market in place of the previous extreme monopolization; changes in production structure, in technologies and in market allocation induced by competition would enhance efficiency; consumers would have a much larger access to more differentiated products, and to better quality goods which would be relatively less expensive. One of the strongest arguments of those reformers who supported the liberalization of imports was based on the previous failures of the reforms to generate competition on the home market. It turned out that the splitting up of some monopolistic large firms did not automatically create competition, because the new rivals (which had anyway been closely related to each other for a long time) found out fast that collusion was more advantageous for them.[6] This was partly due to the fact that all these firms remained state property and the small domestic market was strongly sheltered by import restrictions.

[6] In 1990 the national meat processing trust was decentralized into independent firms in each county of the country. A few months later the Competition Office investigated their collusion because they were raising prices at the same time and by the same percentage. The court imposed a severe punishment on them. Similar collusion was found among the firms of the decentralized milk processing trust. After a number of similar investigations and court sentences the firms became more careful about hiding their collusions.

Trade liberalization was an important part of a package of reform measures which, it was hoped, would stabilize the economy and create a competitive market economy based on private ownership. As far as this particular reform package was concerned, Hungarian import liberalization experience differed in two important respects from most of other countries sharing similar experiences (including other East European transition economies): on the one hand, it was neither linked to a drastic devaluation,[7] nor to an increase of the tariffs rates. (Nagy 1993) The reason why Hungarian import liberalization was more cautious and gradual than that of some other East European economies can be traced back to the fact that the Hungarian economy was more open and much nearer to a state of equilibrium. Consequently, its transition to a market economy was not so much in need of "shock therapy" or a "big bang".

Speeding the liberalization programme required the defeat of its conservative opponents. The conservative counter attack was oriented not only against import liberalization, but against the restrictive monetary policy also. It was well known that for this purpose the threat of an uncontrolled balance of trade deficit would be the best argument, given the fact that the enormous debt burden was the most important impediment to stabilization. However, the old-style bureaucrats could no longer prevail. The international monetary institutions insisted on the continuation and even on the extension of the liberalization and stabilization programme. In addition, and not less important, imports did not surge excessively in the first year of the liberalization process, as has been expected. In fact they grew actually less than exports, thus providing a surplus in the balance of trade.

The implementation of the reform package and especially of import liberalization was strongly influenced by external factors also, of which the most important was the collapse of the Soviet Union and the CMEA. This involved a large reduction of trade among the CMEA's former members. It was partly due to the consequent recession in production that imports increased less than expected. This was followed by significant structural and market orientation changes in foreign trade, and it created very serious liquidity problems and insolvency in a great number of enterprises. The consequence was that their selection depended not on their efficiency, but on their liquidity, on their capital strength or creditworthiness.

The beginning of the import liberalization period was characterized by a general feeling of euphoria following the regained independence of the country, the end of Soviet and communist domination, the high expectations for the results of a democratic election and the introduction of a competitive market economy. Both producers and consumers had been isolated for a long time from western markets, even if the barriers to travel and to import were less rigorous in Hungary than in other Soviet-dominated countries. Foreign trade activities had remained

[7]In fact the value of the forint appreciated significantly during the liberalization period, as is described in the next section.

under the strict control of the authorities. Trading firms and representatives abroad were regularly infiltrated by secret police agents and most of the information and decisions were in their hands. Consumer demand for imported goods was strongly suppressed also, and such goods were available only to a relatively small section of the population (through tourist and business trips) and on the black market.

This explains the first reactions to the introduction of import liberalization measures: several tens of thousands of Hungarians crossed the Austrian border to go shopping. The feeling of euphoria and the "craze" for imported goods did not last long. The recession involved high levels of unemployment, the inflation reduced real wages and consumed much of previous savings. A restrictive monetary and credit policy and the import deposit requirement restrained import growth, even if the currency was not devalued, and the removal of quantitative restrictions was not substituted by other means of protection.

The expectations that the liberalization of imports would help exporters were fully fulfilled. Producers adapted fast to the advantages of the licence-free importation of better quality materials and parts, and they were able to satisfy better and faster the demand of their customers and thus in general they became more competitive.[8] It is difficult to judge the influence of import liberalization on domestic price movement, because the general feeling was that it contributed to the increase of inflation. However, one can hardly distinguish the higher prices paid for better quality or more fashionable goods from the price rises of the same quality products. The most important product groups where there was an obvious restraint on price rises were cars, consumer electronics and personal computers.

Import liberalization and exchange rate policy

At the time of the preparation of the transition to an export-oriented market economy in Hungary there was general agreement among economists devising the reform measures that beside a general deregulation of prices and wages, the liberalization of imports and convertibility would be necessary conditions of an efficiently functioning market economy. It was evident that both of these aims could be achieved only if a macroeconomic balance could be reached, which included the elimination of the excess domestic demand for imports. From the experiences of several countries' import liberalization attempts, it was learnt that to avoid the failure caused by an unsustainable deterioration in the balance of payments a substantial real exchange rate depreciation would be needed. (*Michaely* 1986; Nagy 1991) To avoid or reduce the shock of trade liberalization and the inflationary pressure of

[8] This is well documented in the case studies of *Borszéki* (1993), *Lamberger* (1993), Hajnóczy (1993), *Mohácsi* (1993), Pásztor (1993) and *Révész* (1993), although they could only observe the first period of the liberalization process.

deregulation and devaluation, it was suggested that a gradual import liberalization should be linked to the replacement of quantitative restrictions by tariff increases.[9] It was argued that this could reduce the excess demand for imported goods, and as a consequence, the devaluation could be less than would otherwise be necessary to achieve an acceptable balance of payments.

Neither of these proposals were accepted by the administration when trade was liberalized. Even though the forint was devalued several times, its real exchange rate significantly appreciated.[10] The depreciation of the nominal exchange rate was 50.6 percent in 1991 compared to 1988, versus the basket of currencies to which the forint was informally pegged.[11] However, as domestic prices increased much faster than the nominal depreciation, the real effective exchange rate—which remained relatively stable in 1989—started to appreciate strongly during 1990, resulting in a 19.5 percent appreciation in 1991 (if consumer price indices are used) or 13.4 percent (if producer price indices are used).[12]

The question of why, and how much the forint—instead of being devalued—has appreciated in real terms, is the centre of a debate which is closely related to the institutional interests of those who are taking part in the arguments. The National Bank and the Ministry of Finance, which dominate the exchange rate policy of the government, measure the real exchange rate changes by the producer prices, instead of consumer prices. The former has increased considerably less than the latter.

The Ministry of International Economic Relations[13] (being responsible for the trade policy, for the performance of foreign trade and especially for the trade balance) argues that instead of appreciation, devaluation was, and still is needed. It measures the real exchange rate changes using consumer price indices, and this results in higher appreciation rates. It is evident that devaluation, by making both exports and import substitution more profitable and imports more costly, improves

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[9] The suggestion of Oblath (1991a) and Nagy (1991) was based, among others, on the findings of *Bhagwati* (1978), *Krueger* (1978), *NBER* (1974–78) and (1981–83), Michaely (1986), *Papageorgiou* et al. (1990).

[10] The real exchange rate compares the relative price index of a country to its nominal exchange rate.

[11] Up until the end of 1991 the Hungarian currency was pegged to a foreign exchange basket which reflected the revenue structure of exports. Since then it has been pegged to a basket composed of 50 percent ECU and 50 percent US dollars.

[12] There are great discrepancies in the evolution of real exchange rate indices. The above data come from the Blue Ribbon Commission study, see: *Marer and Oblath* (1992, p. 47) According to the computations of the National Bank the real exchange rate remained stable in 1988–1990, and appreciated 9 percent in 1991 only. See: *Baár* (1992, p.4) According to the computations of *Szentgyörgyvári* (1993, Table 1.), and also of the National Bank, the real exchange rate appreciated in 1991 by 10.3 percent if producer prices are used, by 10.1 percent if consumer prices are used, and by 13.8 percent if unit labour costs are used.

[13] It was called previously the Ministry of Foreign Trade.

the balance of trade and the performance of exports. This is the reason why this Ministry finds real exchange rate appreciation unacceptable and regularly expresses the demand for a devaluation in real terms.[14] It has been stressed that there has not been a single case of a country liberalizing nearly all its imports quickly and, given the collapse of the main markets, appreciation should be regarded as one of the major exchange rate policy aims. (Köves et al. 1993, p. 17) Yet all the other central and east European countries have linked their stabilization and liberalization policies to significant devaluations in real terms. (*PlanEcon* 1992; *Hrncir* 1993; *Jasinski* 1993)

On the other hand, the National Bank argued that there was no need for such a devaluation, for the trade performance of Hungary was much better than anyone expected, e.g. the volume of exports to developed market economies increased by 9.1 percent in 1989, 12 percent in 1990 and 21.7 percent in 1991. (*KSH* 1991, p. 177) The appreciation of the currency in real terms curbs inflation and all political forces in the country regard the reduction of the inflation rate as one of the basic aims of economic policy. Why should we devalue the forint further—the argument goes on—when the black-market rate is not significantly higher, either within the country, or outside of it? Finally, the significant inflow of foreign capital shows that investors regard the actual exchange rates on which they convert their imported capital to forints, and on which they can repatriate their profits, as satisfactory.

The size of real exchange rate changes depends on how one compares and aggregates the price changes of a country to those of international prices. As there are numerous ways to choose the commodities for comparison, and to weigh and aggregate them, there is ample room for different institutions to find their "own" real exchange rate indices, depending on what interests they intend to serve. The divergence of relative prices in Soviet-type economies compared to international price ratios was much greater than their relative development level could explain. Basic consumer goods, state-owned housing and services were strongly subsidized and invested capital was underpriced. As a consequence price liberalization and the elimination of subsidies became very sensitive political issues, for they hurt the interests of a great part of the population. For this reason they could only be implemented cautiously and gradually.

The literature on the developing countries' exchange rate policies reveals that the divergence of real exchange rates indices using consumer prices, or producer prices approximately mirrors the change in the relative price of the tradeable to the non-tradeable products of any given country. (*Aghlevi* 1991; *Edwards* 1992; Oblath 1993b) In the case of the transition in the post-socialist economies this relative price change reflects also the effects of the reductions and eliminations of huge amounts of subsidies and price-distortions. Oblath (1993b, p. 19.) has

[14] This argument was regularly expressed by the Minister. See also: Oblath (1993a) and *Köves* et al. (1993).

pointed out that even if the real exchange rate index based on producer prices "might be a suitable indicator of changes in export price competitiveness, in itself it may turn out to be misleading, [because of] the difficulty of comparing price indices in a period in which acute shortages prevail, with another in which the shortages have been eliminated. The practical implication of this problem is that real exchange rate movements before and after the elimination of shortages (i.e. the pre- and post-stabilization periods) are not likely to be directly comparable... With the elimination (or significant alleviation) of shortages, various types of costs previously associated with, e.g. queuing—evidently not included in the official price index—are also eliminated."

As the costs of waiting in queues or of substitution under constraint are omitted from the price index, one can point out more than the fact that prices and exchange rates are not comparable before and after the elimination of shortages. It means that the price indices in such cases overstate the degree of inflation, and as a consequence the real appreciation is less (or the devaluation is more) than calculated.

One can also question the argument that if the trade performance is good and the balance of trade changes are favourable, there is no need for devaluation. Compared to stable periods of smooth development, in a period of transition, stabilization and great structural changes, trade is more influenced by other factors than exchange rates. The very serious recession following the collapse of the CMEA trade and the financial restriction and stabilization policy of the government—with a host of bankruptcies and with mass unemployment—reduced domestic demand, including import demand. This created a situation in which survival became the most important aim for many companies. This meant that they tried to increase their exports wherever they could, and at whatever prices they could get. Analyzing the profitability of industrial exports, *Antalóczy and Koltainé* (1992) have shown that many of the firms they investigated even exported at a loss, i.e. sold in certain cases below their variable costs. The firms in question covered their losses by selling their stocks, buildings or equipment, or by the insufficient replacement of capital. The Blue Ribbon Commission stated: "it needs to be recognized that in the overall economic climate of 1990–1991, it was export or die for many firms. Therefore, some portion of exports may have reflected a distress response by enterprises to the severe shock of export losses on the CMEA markets". (Marer and Oblath 1992, p. 61)

Inasmuch as imports are reduced by the decline of production and exports expanded even if unprofitable, the improvement of the balance of trade tells us little with regard to the soundness of the exchange rate. It became apparent by the end of 1992 and the beginning of 1993 that the fast increase of exports to the developed market economies was in fact a temporary occurrence, because running through capital is a limited possibility for firms. Bankruptcies and liquidations of

enterprises have been related to about one third of industrial exports and about half of food industry exports according to Köves et al. (1993, p. 7).

Ms. Baár, writing on behalf of the National Bank of Hungary, argues that devaluation is not an appropriate tool for achieving a significant and lasting increase in the profitability of exports. Export sales represented 11 percent of total net sales in 1991 and contributed by only 1 percent to the total decrease of profitability; the latter amounted to 5.9 percent in the same year. (Baár 1992, p. 5) Defending the real appreciation policy of the financial authorities, she used the very questionable argument that devaluation has only a temporary, short-term effect on the promotion of exports and improvements in the balance of trade.

The information content of the black-market exchange rates is also rather limited because the Hungarian currency is *de facto* convertible in the business sector, i.e. it is convertible for the great majority of foreign exchange transactions. Even in the case of households, where the forint is inconvertible, private persons are entitled to place any amount of foreign currency on foreign exchange accounts without the obligation to declare the source of it, and they are also authorized to take it out of the country. As a consequence the formally illegal, though not tightly controlled "curbside market" mainly shows the changing offer and demand conditions of tourists. Also, the propensity for household savings to be kept in convertible currencies represents only a very limited amount of the total demand for foreign exchange. While in the late eighties the black-market rate for foreign exchange was some 10 to 30 percent above the official rate, the gap started to narrow in 1990 and has since then become insignificant. According to several experts this evidence does not suggest a fundamental misalignment of the official rate. (Marer and Oblath 1992, p. 60)

Is the fact that Hungary recorded the greatest capital inflow among the Central and East European countries an indication that the exchange rates are correct? For example, in 1991 the National Bank recorded more than US$3 billion of medium and long term capital assets, half of which represented net foreign direct investment. It is obviously very difficult to get detailed information on what actually motivated foreign investors, but it seems quite probable that a major part of what was recorded as foreign direct investment was in fact in the form of short-term deposits with commercial banks. These have been attracted by the relatively high interest rates. It is estimated that only a small part of these investments have been spent on the much needed modernization of equipment and on technical development, i.e. on machinery imports. Consequently most of the capital inflow has contributed to the appreciation of the forint in real terms or, by extending the monetary base, to the inflationary pressure.

Hungary is a highly indebted country. At the end of 1991 its gross foreign debt in convertible currencies stood at $22.7 billion. This meant a more than $2000 *per capita* debt—one of the highest in the world. The annual principal payment to service the debt is approximately US$2.5 billion and the net interest payments

are US$1.4 billion. Debt servicing amounts to about 12 percent of GDP, of which interest payments represent approximately 4 percent.[15] If it is measured against receipts from exports in convertible currencies (the "debt service ratio"), it declined from 97 percent in 1968 to 40 percent in 1991, due to the reorientation of trade and to the change to convertible currency settlement in trade with former CMEA countries.

In Hungary practically all significant political forces agree that the foreign debt has to be serviced fully, and no attempt has been made to renegotiate or to reschedule the external payment obligations; this is in contrast to the policy of several other indebted countries. Consequently, with creditworthiness achieved, the principal payments can usually be rolled over, meaning that the burden is reduced to interest payments, which in 1991 were US$1.3 billion. This was fully covered by the surplus on the non-interest current account (NICA) of US$1.6 billion in the same year. The net resource transfer of paying interest on the accumulated debt by the surplus of exports and the tourist trade is reduced by foreign direct investments, which amounted to US$1.5 billion in 1991. As the total inflow of capital (currency deposits, portfolio investments, new credits etc.), beside the foreign direct investments and the NICA surplus, largely exceeded interest payments on foreign debt, the reserves of the National Bank increased substantially. The government was very proud with these results and their financial experts regarded them as proof that there is nothing wrong with the actual level of the exchange rates, including their appreciation in real terms.

Nevertheless, one should keep in mind that much of the capital account surplus is the result of a substantial inflow of volatile short-term deposits, which can disappear just as fast as they came, depending on the political climate and on economic policy changes. On the other hand, foreigners make direct investments not to cover the interest payments on previous debts, but to make and repatriate profits—if possible even at an early stage. Consequently, even if capital inflow can temporarily alleviate the debt burden, in a longer-term perspective the net resource transfer has to be covered by the surplus of trade in commodities, services and tourism.

Oblath (1993a) has drawn attention to the danger of the development of an "exchange rate bubble" as a consequence of capital inflow and trade surplus following recession. The appreciation in real terms may diminish the competitiveness of producers, thus aggravating the recession and reducing the inflow of foreign capital.

The exchange rate policy is—as is clear from the above—closely related both to the general aims and priorities of economic policy and to the interests of the different institutions participating in the decisions on policy directions. If the major priority is to keep the current account in balance (as it was between 1982 and 1988,

[15] The debt-service burden could become even higher if GDP declines even further. See: Marer and Oblath (1992, p. 42)

because of the heavy debt burden and serious liquidity problems), then a continuous devaluation both in nominal and real terms is advisable, because it helps export expansion and curbs import increases. (Baár 1992, p. 2) Yet if the major economic policy target is to stop, or restrain inflation, then a real appreciation may become beneficial, because it can avoid the development of a "price-devaluation-price" spiral and it can cool down inflationary expectations. This was the case after 1989 and the reason why the financial authorities followed a policy of appreciation in real terms. Nevertheless, the field of manoeuvre for exchange rate policy is narrow in reality because the serious macroeconomic consequences of bad decisions soon become evident, as really happened when exports started strongly to decline at the end of 1992 and beginning of 1993. (Köves et al. 1993) On the basis of these experiences it can be stated now that those who criticized the government policy of real appreciation were right, and even if a very strong devaluation was not needed the exchange rate in real terms should have been kept in line with the inflation rate.

The conflict of interests and the reasoning of the different institutions concerning priorities hides a deeper layer of conflict. This seems to be even more important than the temporary changes of priorities and policies. The fundamental problem behind these discussions is: how much efficiency pressure should or could be exerted on the enterprises and when? The transition to a profit-motivated market economy means large scale structural change in an economy where profitability has been neglected. This involves great unemployment, capacity losses, devaluation of capital assets, and the loss of markets. The devaluation of the currency increases the profitability of both exporting and import substituting firms, and thus alleviates the pressure for structural change and helps the survival of these firms. As a consequence unemployment is reduced, or its growth becomes slower, and there are less bankruptcies and more time and possibility for adaptation. If, however, the nominal devaluation does not keep pace with the inflation rate, the efficiency pressure increases, life is harder and survival is more difficult for the firms. However, the necessary changes due to the increased competition arrive much faster. It is not an easy choice for policy-makers to find the right path by which the pressure is strong enough to create the conditions of productivity growth, but not so strong, as to ruin the perspectives of adaptation and create unbearable social tensions. One should add to this that the profitability pressure depends more on the motivation or incentives of firms and managers than on relative prices and exchange rates. This means that the privatization process, and the methods used for controlling the state-owned firms, play an even greater role in structural change.

The future of exchange rates is closely related to the convertibility of the forint, which in Hungary is beyond the scope of the import liberalization period. There seems to be general agreement that to reach the right moment for this in the transition period, a number of macroeconomic conditions have to be satisfied (Marer and Oblath 1992, pp. 8–10) and the adjustments of the exchange rates

should increasingly reflect market forces, the financial authorities influencing it more and more by market interventions in order to stabilize it around the level determined by the offer and demand conditions. An important step was made in this direction in mid-1992, with the introduction of an interbank foreign exchange market. Commercial banks were allowed to hold a certain amount of foreign exchange on their own account and to trade it on a rather narrow band around the official midpoint rates. It is projected that by widening the range of interbank trading, and by increasing the amount of foreign currency citizens can buy, and by learning how a floating exchange rate system can be managed, a gradual integration of the interbank and curbside markets will be achieved.

Resistance to liberalization

It was surprising for observers of the liberalization process how little resistance was exerted against it in the period of preparation and shortly after its introduction, i.e. in the years 1988–1989. There are several possible explanations for this unusual occurrence. Gács (1991), for example, has argued that other shocks affecting the enterprises, like the liquidity crisis, the crash of rouble exports, increased inflation and high interest rates, and the serious uncertainties linked to transition and privatization, created more immediate difficulties and dangers for them than the longer term threat of import liberalization.

Another important factor has been the incentive system, which has influenced and even dominated the behaviour of Hungarian firms (in fact, their behaviour changed significantly in this period), but which has not moved in the direction of that might have been expected from enterprises functioning in a competitive market environment. In this respect it was far from true when the government's report to the GATT stated that state-owned companies: "operated the same way as the private sector, i.e. strictly according to commercial considerations. The major issue was not the ownership, but the *modus vivendi* of enterprises. In this respect there was no difference in Hungary between private and state-owned companies." (GATT 1991, Vol. II. p. 134. Report by the Government of Hungary)

If it were true, there would be no need to privatize during the transition process to a market economy. In fact, state-owned enterprises behaved very differently from the privately-owned ones, especially from those private enterprises which function in a settled and competitive environment. The political upheavals strongly affected the mentality, the motivation and the behaviour of managements: they had to prepare for the radical political change in the bureaucratic control of their enterprises, they had to anticipate privatization, work out how to keep their positions, and how to please both the future administration and the possible future proprietors. Another major concern was not to antagonize either the white collar

or the blue collar working force of their enterprise by drastic changes or mass lay-offs, and if possible to be assured of their support, given the likelihood of future confrontations with the state administration.

Many firms were in a crisis situation, their major foreign markets in the CMEA countries had collapsed, domestic market demand had gradually shrunk, liquidity troubles had increased, and more and more loss-making firms went or were going to be bankrupt, and the domino effects of lost customers threatened them. The managers knew best how much their enterprises needed to be reconstructed, how much of the embodied capital was poorly invested and how little it could be moved or changed. Much of this inflexibility was due to the heavy financial cost of the inherited capital stock which they had to bear, this cost being out of proportion to the actual worth of this capital. There was great uncertainty as to the amount of superfluous real capital and the previous non-performing loans that could be written off without creating a wave of bankruptcies in the financial institutions.

Under such conditions it was no surprise that the managers became, and in a sense had to be, very short-sighted; their major concern became simply: *survival*, both for the sake of their firms and for themselves as managers. They did not care much about the problems of increased productivity, profitability, about flexible adaptation to changing demand and market conditions, and even less about the longer term danger of the competition that would be created by import liberalization.[16]

What the managers mainly perceived at the time of the preparation and introduction of import liberalization was an extended freedom to buy what they liked from where they liked for production and investment purposes. As it coincided with the shrinking supply from the former CMEA countries, the importance of such freedom increased greatly. It seems quite probable that if there had not been fast liberalization of imports the recession of production and the economic and financial hardships following it would have been much greater than they actually were.

Another explanation for the weak resistance to liberalization is given by Gács (1993): "the usual pressure groups resisting economic reforms were either non-existent or virtually ineffective... After the changes of 1989, the party-state did not exist any more and the behaviour of the state (including the branch ministries) was dominated by pro-liberalization policies of the government. Earlier, managers had traditionally derived their power from their close relation to the communist parties. With the disappearance of this background, most managers felt themselves discredited and for the sake of survival in their old positions, they did not attempt at making any noise, even when the interest of their enterprises became seriously

[16] Interviewing several managers of big state-owned enterprises at the time, Szalai (1992, p. 13.) observed: "Their basic objective is to preserve the framework of their enterprise, or at least to minimize its reduction, and not to pursue profitable economic activity."

endangered. Old trade unions were also discredited and the new ones were either supporters of the new government, or were too immature to act effectively".

As the experiences of previous trade liberalization attempts have shown, the strongest resistance jeopardizing its success or endurance has usually come from interest groups, like employers organizations, trade unions or agrarian lobbies.[17] It seems to be one of the necessary conditions of a successful liberalization episode that the interest groups hostile to it should be emasculated or paralyzed.[18] In many instances, as in the cases of Korea, Chile, or Turkey this was linked to an authoritarian, or dictatorial political change; in other words the introduction of military rule created a kind of "political vacuum". There are opposite examples of trade liberalization in which, instead of coercion, an agreement or compromise is achieved between the government intending to attain faster growth by opening the economy, and the different social interest groups. The latter agree to support or at least be neutral towards the introduction of a liberalization cum stabilization programme. This was the case with the liberalization agreement reached with the trade unions in Israel in 1962, with the Moncloa-Pact of 1977 in Spain, or with the Mexican stabilization pact of 1987. (*Székffy* 1993; *Stenzel* 1988; *Aspe* 1991)

In Hungary, however, trade liberalization was prepared by the last communist government and implemented after it was overthrown, i.e. not with the introduction but the removal of an authoritarian regime, and not based on a formal agreement with the interested social organizations. The different interest groups were not emasculated, and much of the institutional structure was left unchanged, but they were marked by temporary inertia and a policy of wait and see. Beside the fact that the surviving special interest organizations became weaker, less influential or discredited, for the reasons mentioned above, at the beginning of the liberalization process they did not realize the likely consequences of import competition.

Another factor was that after a very long period of nearly total monopolization in the economy, nearly absolute elimination of import (and domestic) competition, there was a very widespread understanding in society that a transition to a market economy was needed, and that this would be characterized by the private ownership of the factors of production in the competitive sector.[19] Thus this general mood in society eliminated practically all resistance to the introduction and legalization of competition, including competition from foreign companies. As a consequence, one can say that even if there was no formal pact between the new government and the interest organizations concerning trade liberalization, there was a tacit agreement supporting it.

[17] See a comparative analysis in *Greskovits* (1993, pp. 26–32).

[18] This is paraphrasing *Olson*'s (1982, p. 75) statement that the emasculation of distributional coalitions by military occupation was a cause of fast growth in West-Germany and Japan.

[19] At the first free election in early 1990, practically all political parties were in agreement on these basic issues, including the former communist party.

It is also true that this understanding was based on many illusions concerning the advantages of a market economy in general and of competition in particular. It took a certain time until the exaggerated expectations proved to be unrealistic and both the management of enterprises and the different interest groups realized how much they were being or could be harmed by unrestrained competition.

The factors enumerated above contributed to the ostensible lack of resistance to import liberalization in 1989–1990. The behaviour of both the consumers and of the business community was motivated mainly by the advantages of the disappearance of many shortages due to the inflow of imported goods. However, the "honeymoon of trade liberalization"[20] did not last long, for during 1991 and especially since 1992 more and more voices could be heard demanding protection for domestic producers. Consumers complained of high prices and induced price increases due to imported goods, and producers deplored the increased crowding out of domestic production. Gács (1993) observed that the enterprises that first awoke to the new opportunities of protection were the newly-created joint ventures: "Investing with concrete business targets, more skilled in lobbying, and possessing more means for blackmailing domestic authorities, they were fast, aggressive and efficient. Many foreign investors targetted their sales neither on western markets, nor on eastern countries, but aimed to capture domestic demand".

This business tactic is of course familiar to multinational companies all over the world, but in the case of the previously centrally planned countries they could make use of the inherited monopolistic structures.[21] Thus it was joint ventures that were the first to ask the government for protection against import competition, elimination or reduction of tariffs on their inputs, and tax exemptions. Next came the agrarian lobby, which was strongly hit by the shrinking eastern markets and the loss of different subsidies. They succeeded in several instances in getting quantitative restrictions on imported food products in order to preserve much of the home market for domestic producers. Their argument was partly just, for it was true that their main competitors, the farmers in Western Europe, were strongly protected and subsidized and the sale of their surplus reserves at low prices menaced Hungarian farmers and crowded them out from the home markets.

These were followed by other industries demanding increased protection, like coal mining, which demanded that the state-owned electricity trust be obliged to buy only Hungarian coal up to a certain quota. Interest organizations representing light industry demanded quantitative restrictions on the imports of sensitive products, arguing that many partner countries used similar methods against Hungarian exports. Steel and cement producers also complained and asked for protection against imports being sold at allegedly dumping prices from the former Soviet-bloc

[20] The apt expression is that of Gács (1993, p. 19).

[21] This was the case with the General Electric-Tungsram electric bulb factory, Electrolux-Lehel refrigerator producing company, Unilever-TVK detergent factory and several others.

industries. They asserted that the continued subsidization of energy prices in these countries allowed them to export these products much below world market prices.[22]

As the demand for protection was increasing and the traditional means for achieving it were diminishing, interest grew in the introduction and extension of new forms of protection which did not violate the GATT rules.[23] The newly established Competition Agency of the government quickly learnt this and is in fact now teaching domestic enterprises how to prepare and present complaints dealing with anti-dumping and market disruption procedures. However, as the verification of these complaints is difficult and the procedures usually take a long time, they are not much of a help when foreign goods are flooding the domestic market.

More and more voices can be heard demanding increased administrative or procedural protection, such as special health, environmental, quality and trademark requirements. This would all mean that special licences would have to be obtained from different (and sometimes several) administration agencies for importing goods falling under these rules. The "new protectionists" have given advice on the setting up and changing of these rules and have declared that the procedure should be extended in such a way as to put the foreign firm at a disadvantage. One of their main arguments is that similar invisible trade barriers and discriminatory measures are applied against Hungarian products in developed markets, like those of the US, the European Union or Japan.

Another well-known method of providing preferences for domestic producers is the lack of neutrality in Government procurement. While the privatized sector is still small, and even in many joint stock companies the state owns a large part of the shares, the possibility of influencing procurement decisions in favour of domestic firms is great. Even if guidelines on tendering procedures exist, the policies, criteria and institutional procedures used in this field are still not really clear.

The Government's representative before the GATT Council pointed out that the requests for the reintroduction of import licences and for tariff increases had been growing by the hundred in the recent years. (GATT 1991, Vol. II, p. 137) It was observed that even if the authorities were opposed to these growing pressures, the resistance had weakened. As the popularity and support of the government was gradually decreasing and the next election for parliament was approaching, there

[22] The growing demand for tariff protection is discussed in Nagy (1993). The number of articles in the daily and weekly Hungarian newspapers demanding more protection for home-made products could be counted in tens in 1991, but numbered over one hundred in 1992. An Association for the Protection of Hungarian Industry (Védegylet a Magyar Iparért) was established in July 1992 by the top managers of the major industrial firms and the Hungarian Chamber of Economy asking well-known politicians, scientists, journalists and artists to join industrialists in a campaign for the survival of Hungarian manufacturing. (*MH* 1992).

[23] In response to a request of the Hungarian Ministry of Industry and Trade, *Török* (1992) prepared a report detailing the more sophisticated methods of "new protectionism" applied by several industrial countries and urged their implementation.

could be little hope for a more resolute stand in resisting protectionist tendencies. However, international obligations will limit and impede a significant retreat in the sphere of import liberalization.

Structural changes in imports

The most striking structural change in the liberalization period has been the strong decline in the share of import materials (mainly used as production inputs), and the fast increase of the share of consumption goods imports. The share of materials in total imports declined from 51 percent in 1988 to 37 percent in 1991, which meant a reduction in volume terms of 21 percent in three years. On the other hand, the share of consumption goods nearly doubled between 1988 to 1991 from 12 percent to 22 percent of total imports, increasing their volume by 71 percent (*Table 1*).

Table 1

The commodity structure of imports 1988–1991 (in percent)

Commodity groups	1988	1989	1990	1991
Fuel, electricity	13.0	10.9	13.5	15.0
Materials	51.2	50.3	45.9	37.1
Machinery	16.7	17.8	18.0	20.4
Consumption goods	11.8	13.8	14.9	21.7
Food, agriculture	7.3	7.2	7.7	5.9

Source: KSH (1990) and NGKM (1992).

Two major factors have influenced these changes in the structure of imports. On the one hand a "normalization" effect has corrected the distorting character of central planning on the structure of imports: it had previously strongly diminished the share of consumption goods and increased the share of material inputs. The collapse of eastern markets and the decline of production have contributed significantly to the decrease of import demand for materials. It should be noted that in the case of consumption goods the "normalization" effect worked even if the great majority of this product category was not liberalized but remained restricted by quotas. Liberalization of imports in this case did not mean the removal of the licensing system but liberation from the dictates planners imposed on consumers' satisfaction. The import structure of the centrally planned economies was distorted compared to some European countries. The share of consumption goods in imports was in the range of 11–19 percent for three East European countries in 1980, while in Western Europe their share was between 24–37 percent. The difference in these shares increased significantly over the next ten years. (Nagy 1993)

While the volume of total imports remained relatively stable in the import liberalization period, beside the important structural changes already mentioned, one can observe the growing share of machinery imports from 17 percent in 1988 to 20 percent in 1991, representing an increase in volume terms of 21 percent. This seems to be surprising taking into account that investments declined both in 1990 and 1991.[24] One probable explanation for this is that a significant proportion of the machinery imports are repair parts or inputs for consumption goods (like parts for previously imported cars or tubes for TV sets) and not investment goods. Therefore, much of the growth was due to these items.

Beside the changes in the commodity structure, a very marked reorientation of trade can be observed in *Table 2*. While the volume of imports from the former Soviet-bloc countries was reduced to less than half (45.5 percent), those of the developed and developing market economies increased by 44 percent in three years, between 1988 and 1991. The most explosive growth could be observed in the volume of consumption goods imports from the market economies: 196 percent and in machinery 112 percent. These tendencies can also be regarded as a part of the "normalization" of imports, in this case in the sense of its market structure. The political preferences of the ruling communist party and the planning system itself always had a strong bias for favouring trade with the Soviet Union and other CMEA countries, and this was especially strong with manufactures, like machinery and industrial consumption goods.[25]

Table 2

Trade volume changes 1988–1991 (1988=100.0)

Commodity groups	Economies in transition	Market economies	Total
Fuel, electricity	67.7	155.2	98.4
Materials	38.2	97.2	78.9
Machinery	19.7	211.8	120.5
Consumption goods	47.4	295.5	171.0
Food, agriculture	75.8	110.8	103.1
Total	45.5	143.9	101.1

Source: KSH (1991)

Beside the "normalization" of both the commodity structure and the market orientation of imports, the liberalization process obviously has had an effect which has caused serious concern: how does it affect domestic production? How far is it,

[24] The volume of investments declined in 1990 by 9.8 percent and in 1991 by 11.9 percent (KSH 1991, p. 3).

[25] For more detail see: Nagy 1985; 1990.

or can it become competitive, given the unimpeded inflow of foreign made products? The lack of competitiveness of the monopolistic, unresponsive state enterprises was one of the main arguments of the conservative economists in the socialist countries against opening and liberalization. One of the rightful concerns in the transition period is, how much efficiency improvement can be achieved and how soon will it be able to resist foreign competition, and how will privatization and foreign capital investments assist this development?

It is usual in international practice that at the beginning of the liberalization process temporary measures are introduced to curb imports and to give a breathing space to domestic industries in order to enable them to prepare for the freer competition with imports. As we have seen, trade liberalization in Hungary has not been accompanied either by a significant devaluation, or by tariff increases. The only measure implemented to restrain imports has been the import deposit system.

As the statistical categorization of production and trade is largely incongruous, it is very difficult to measure how far the penetration of imports has displaced domestic producers from their traditional markets. The great number of bankruptcy and liquidation procedures and the high level of unemployment certainly show that the effects of liberalization seem to have had very serious consequences, but it appears to be impossible to separate them from other factors, such as the collapse of the eastern markets and the general decline of domestic demand.

Gács (1993) computed import penetration ratios for some sectors and found that western imports penetrated at the expense of both domestic production and eastern imports in 1989–1990. It is quite likely that more domestic production was crowded out in 1991 and 1992, and much of the complaints of different industrial organizations in this respect were justified. One should also be mindful that after the very serious decline in production and capacity utilization, even a relatively small loss of the domestic market can be very painful for many Hungarian enterprises. One can also expect that the threat of losing traditional markets increases the efficiency pressure on the previously protected firms, and thus by modernizing their technologies they will be able to defend or regain their markets. It is one of the basic aims of import liberalization to enhance the productivity increase of domestic firms by competition, but this is only possible if they are able to survive and to adapt to the new conditions. Industrial and trade policy, which is gradually decreasing protection and increasing competition by trade liberalization, is in this sense an art which is hard to learn.

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COMMON PATTERNS AND PARTICULARITIES IN PRIVATISATION: A PROGRESS REPORT ON THE TRANSITION ECONOMIES*

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Privatisation has become irreversible in all post-communist economies. The pace is slower than anticipated, though, surprisingly, privatisation has met little open public opposition. It seems that different reasons explain the sluggishness in Eastern Europe on the one hand, and in the former Soviet Union on the other. In Eastern Europe, governments lacked the necessary determination, in spite of relatively favourable socio-political conditions. In the former Soviet Union governments have launched bold, untested schemes in chaotic situations (disputed borders, civil wars, hyper inflation, etc.)

I. Introduction

Privatisation is gradually making headway in all transition economies. Over the past three years marked progress has been made in agriculture, and in the privatisation of small business and the urban housing stock. However, progress has been less rapid at the core: i.e. the medium and large-sized state-owned enterprises (SOEs). In addition to this, virtually nothing has happened in the banking sector. This unevenness is understandable—many observers were already warning in 1990 that privatisation would be an immensely complex task, with a long time horizon under the best of circumstances. However, the changes which have occurred over the past three years, taken together, fall short even of these "realistic" expectations.

First, although institution-building and the creation of the necessary legal framework have accelerated, big gaps remain.[1] In several Soviet successor states and also in Albania, "large" privatisation was formally suspended in the course of 1992 or early 1993. True, these suspensions were relatively short-lived almost everywhere but they nevertheless indicate the underlying tensions. Other countries—including the three "advanced" reformers of Czechoslovakia, Hungary and Poland—have moved ahead on most fronts, but the speed of change has remained behind declared intentions in these economies as well.

The *second* general observation is that the overall socio-political conditions have been significantly less favourable than expected. In early discussions on the

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[1] For a recent overview of the principal laws on privatisation, see *U.N.* (1992a)

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modalities of privatisation, a certain consensus was reached that "foundations must be laid first", (*Zecchini* 1993) including elected governments with popular support, competent public administrations, functioning legal instruments, liberalisation of economic activity, a viable banking system and—at least as important as all the other factors—macroeconomic stability.

However, up until now many governments have been unable to satisfy these requirements, and there is no hope of achieving them during their expected tenure. Yet privatisation was for these governments also a political promise—hence their desire to move ahead in spite of unfavourable circumstances.[2] Moreover, it has often been argued—not without some justification—that swift advancement on the privatisation front would help to achieve many other goals as well. Acting under such pressures, governments find themselves in a situation where the range of options is limited to a choice between bad and worse.

The *third* and perhaps most unexpected development is that the actual changes that are occurring in the transition economies are more similar to each other than could have been assumed two years ago. It seems that priorities, policies, instruments and proportions are converging in spite of the fact that countries started out from rather different positions and the first privatisation programmes evinced a great deal of diversity. Now it seems that practically all conceivable privatisation mechanisms have already been applied or seriously contemplated. There is no such thing as a mainstream method. Of course, the relative proportions vary from country to country, but not as much as the original privatisation scenarios had indicated.

Fourth, it is interesting to observe that, so far, privatisation has met relatively little open public opposition, given the magnitude and importance of the underlying changes. Thus at the time of writing there has been only one example of forceful resistance: in 1991 the head of the German privatisation agency was murdered by leftist terrorists. However, as a general observation it is more appropriate to emphasise that the populations of the transition economies have reacted to privatisation with surprising calmness. There has been only one reported case—in Lithuania—when public protest was specifically targeted against privatisation, and this led to street demonstrations and strikes.

The objective of this study is to provide an overview of the progress achieved in privatisation; discussion of the merits and demerits of various methods of privatisation will therefore be kept to a minimum.[3] The first section recalls a few salient points which were highly debated in 1990/1991. This is followed by a description

[2] As two observers noted on recent developments in Russia, "Privatisation is now emphasised for the perfectly legitimate political reason that it is about the only piece of positive news that the government can offer". (*Lainela and Sutela* 1992)

[3] For a comprehensive survey of these issues, as well as for a review of the literature, see *van Brabant* (1992).

of privatisation institutions and the course of their development up until late 1993 (sections III and IV). The most interesting elements of the privatisation process, the so-called large privatisation, is discussed in section V to VIII. The discussion is rounded off by a review of data on the size of the private sector and its relative share within the individual transition economies at the end of 1992. Three other important aspects—small privatisation, restitution, and the specificities of the agricultural sector—are not covered in this paper for reasons of space.

II. The framework of analysis

The present survey is a continuation of previous research work conducted in the United Nations Economic Commission for Europe secretariat; the definitions and concepts used here are the same.[4] Thus, for the purposes of this analysis privatisation is understood as all those actions which take the state out of decision-making concerning *existing* capital assets. Hence the start-up of new private ventures is not covered in the definition.[5]

Privatisation is an issue of political economy *par excellence.* Governments undergoing economic transition cannot forget that the capital assets they have inherited were mainly created by the work of a generation which is politically still active. It is little wonder that the latter want their views to be heard and their interests represented when the future of "their" capital is decided.[6] When an entire country is restructured according to the needs of a market economy, jobs and power positions are redefined at all levels. It is hardly necessary to re-emphasise that this "creative destruction" leads to rapidly growing unemployment; that was to be expected, and a great deal of attention has been devoted to this. Yet it is less frequently mentioned that restructuring existing capital assets also means a redistribution of economic power and political influence. New elites are created, consisting partly of self-made men, partly of political appointees. It is a common experience in the region that governments are inclined to help their own clients scale new heights (top management positions, seats on supervisory boards, etc.). This inevitably gives rise to resistance from the opposition and among ordinary citizens. Finally, it needs to be understood that, under the conditions of systemic transformation, privatisation means not merely a redistribution of ownership rights among existing economic agents. New agents, new institutions are created day by day. The stakes are high: once institutions have become rooted in society, they are

[4] See U.N. (1991, pp. 124–183; 1992b, pp. 191–256; 1993, pp. 191–216).

[5] But see sections IX and XI below on this important subject.

[6] As a Hungarian observer has noted, people are deeply suspicious about privatisation when somebody else gets something: "*He* runs away with *my* national wealth." (*Köllő* 1990)

likely to persist for a long period of time.[7] This is one reason for the resistance met by governments in parliaments when ownership issues are being debated.

Estimating the asset value of the very large number of state-owned enterprises (SOEs) is a hazardous undertaking under the best of circumstances, let alone in the inflationary environment which prevails in many transition countries; the costs of such assessments can in general be justified only on behalf of owners or potential owners.[8] It is erroneous to believe that the market value of an SOE is a given magnitude, somehow intrinsically frozen in land or tangible assets, and that once the right accounting expertise is acquired (or hired from abroad), these figures can be worked out with unquestioned objectivity. Ultimately, the market value of an SOE is determined by the interplay of supply and demand forces.[9] In fact, when it comes to putting a price on a company, experience has shown that for Western investors tangible assets (land, buildings, machinery and equipment, etc.) are of the least importance. They do not really need additional capacities—they need new markets.[10]

III. Agents of privatisation

One of the most striking observations that a cross country comparison of privatisation practices reveals is the similarity of institutions. It seems that more and more countries are finding it necessary to create a structure which rests on the same three main pillars: a privatisation ministry, a privatisation agency and a state holding (*Table 1*).[11]

At the government level, a *privatisation ministry* is in charge of the development of strategies for industrial and service enterprises. Privatisation in agriculture is typically run by a special unit of the ministry of agriculture. In some countries—notably in Russia and Hungary—privatisation is supervised by a cabinet member—a privatisation or a reform minister.[12] In Ukraine, privatisation is largely controlled

[7] On this point, see *Targetti* (1992).

[8] A useful review of accounting and valuation issues, based on recent experience in some east European economies, can be found in *OECD* (1993).

[9] For a detailed illustration of these problems see *Mihályi* (1993).

[10] The unification of Germany can serve here as a telling example. Public opinion surveys among enterprises already privatised in the former GDR show with total clarity that the value of these assets was greatly dependent on the availability of the Eastern markets; this was simply because the *raison d'etre* of these firms had originally been based upon the unsatiable absorption capacity of these markets.

[11] In some countries (e.g. Bulgaria, Poland) the local authorities are also given a role with a mandate to privatise firms where historically they are the founding organs.

[12] Although a rare exception, it is telling to note that in June 1993, the Slovak Prime Minister V. Meciar was forced to take over the Privatisation Ministry himself in order to avoid a major political crisis.

by the Ministry of the Economy, although until March 1992 the Ministry of Destatization and Demonopolization of Production was also involved.[13] As often happens, the name of the privatisation ministry indicates the basic policy orientation or at least the orientation that the lawmakers had originally intended. In Poland, for example, the designation "Ministry of Ownership Changes" (rather than Ministry of Privatisation) served to indicate that privatisation would be only one of several forms of ownership change which ought to be taken into consideration.[14] There are only a few countries where privatisation of SOEs has been left entirely in the hands of the branch ministries. This seems to be the case in Romania and Latvia,[15] and to some extent in Bulgaria.[16] It is a more frequent phenomenon, however, that the mandate to run and privatise a few very large SOEs—chiefly public utilities, such as the postal service, railways or water management—is granted to the relevant branch ministry.[17]

The operational work of privatisation is usually given to a *privatisation agency*. In addition to the practical work, these agencies are responsible for the elaboration of the governments' annual privatisation plans.[18] In these a detailed account is given of the intended course of privatisation, the number of firms involved, and the utilisation of privatisation revenues. Very often, the agency is subordinated only to the government (Albania, Hungary) or to the ministry of the economy (Estonia). For a while (six months) the Hungarian authorities gave the privatisation

[13] In 1991, the Ministry of Privatisation played an important role in the development of the privatisation concept, but its role dwindled on. (*Johnson and Eder* 1992)

[14] For a detailed account of the 1990 controversy between the Mazowiecki government and the Sejm on these issues, see *Fallenbuchl* (1991).

[15] In Latvia, each ministry has a licence to privatise firms under its control, although the Ministry of Economic Reforms must grant final approval to all sales.

[16] At one stage, Bulgaria's privatisation programme was entrusted to the Minister of Industry, I. Pushkarov. When he was forced to resign, a National Agency for Privatisation (the second institution under the same name) was formed (*East European Privatisation News,* Vol. 1, No. 9, September 1992, p. 7). More recently, the new Minister of Industry, R. Bikov, has taken over many aspects of the privatisation process, including the licensing of joint ventures (see Mr. Bikov's statements in the National Assembly on progress in privatisation, quoted by the BTA news agency: BBC, *Summary of World Broadcasts,* EE/W0267,4 February 1993).

[17] There are, however, interesting country-specific solutions. In the latest Slovenian privatisation strategy, for example, it is envisaged that in such companies ownership rights will be separated from management rights. Thus, some 150 infrastructural companies will be run by branch ministries, while the ownership function will be placed in the Treasury.

In Poland, two branch ministries are involved in privatisation in addition to the privatisation ministry. The Ministry of Finance is responsible for banks, and the Ministry of Foreign Economic Relations is in charge of privatising the state-owned foreign trade companies. In addition to all this, the State Agency for Agricultural Ownership is responsible for the farming sector.

[18] In practice, this has become almost irrelevant in many countries. Due to the lack of consensus over fundamentals, governments are often unwilling to submit these documents to public control. At least in three countries—Bulgaria, Hungary, Russia—the 1993 privatisation policy document was not approved until as late as mid-1993.

Table 1

State institutions involved in the privatisation process

	Ministry or Minister responsible for privatisation	*Privatisation agency*	*State asset-management fund(s)*
Albania	–	Preparatory Commission for the Process of Privatisation; National Privatisation Agency	–
Bulgaria	–	Privatisation Agency	State Fund for Reconstruction and Development
Czechoslovakia	–	–	Federal Fund of National Property
Czech Republic	Ministry of National Property Administration and its Privatisation	–	Fund of National Property
Slovak Republic	Ministry of National Property Administration and its Privatisation	–	Fund of National Property
Hungary	Minister without portifolio	State Property Agency	State Holding Company
Poland	Ministry for Ownership Changes	–	–
Romania	Branch ministers	National Agency for Privatisation and Development of Small and Medium-Sized Enterprises	State Ownership Fund
Yugoslavia (SFR)	–	–	–
Bosnia-Herzegovina	–	–	–
Croatia	–	Agency for Restructuring and Development[a]	Fund for Development[a] Retirement Fund for Employees Retirement Fund for Agricultural Workers
Macedonia	–	Transformation Agency	–
Slovenia	–	Privatisation Agency	Privatisation (Development) Fund
Yugoslavia (FR)	–	–	–
Serbia	–	Privatisation Agency	Development Fund of the Republic
Montenegro	–	Agency of Montenegro for Economic Restructuring and Foreign Investment	Development Fund of the Republic

CIS			
Armenia	Committee of Privatisation and Management of State Property	Under consideration	–
Azerbaijan	–	–	–
Belarus	Committee on the Management of State Property	State Property Agency	–
Kazakhstan	Ministry for Privatisation State Committee on Property	–	–
Kyrgyzstan	–	–	–
Moldova	–	–	–
Russia	First Deputy Prime Minister[b]	State Committee for the Management of State Property (Goskomimushchestvo)	Fund of the Assets of the Federation
Tajikistan	Committee on State Property	–	–
Turkmenistan	State Committee on Privatisation	–	–
Ukraine	Minister of Economy Ministry of Destatisation and Demonopolization of Production Minister of Privatisation	–	State Property Fund
Uzbekistan	–	State Committee for the Management of State Property (Goskomimushchestvo)	–
Georgia	State Committee on Privatisation	–	–
Estonia	Ministry of Privatisation State Property Department of the Ministry of Finance[c]	Government Agency for the Privatisation of State Property[c]	Under preparation
Latvia	Branch ministries	–	–
Lithuania	Minister of Economy Department of Privatisation	Central Privatisation Commission of the Government	–
Ex-GDR Länder	–	Trust Agency (Treuhandanstalt)	–

[a]Merged in early 1993, under the name "Croatian Fund for Privatisation".
[b]Head of the Privatisation agency.
[c]Merged in mid-1993.
Sources: Official reports, national newspapers.

agency total independence, subject only to parliamentary oversight. However, this organisational set-up was quickly abandoned and—as far as is known—was never followed by any other country. Bulgaria adopted a mixed approach: 6 members of the agency's 11-men strong Supervisory Council are elected by the National Assembly and the government has only 5 guaranteed seats.

There is more diversity with respect to the legal status of the privatisation agency. One approach, first initiated by the then still existing east German government, is the *Treuhand*-model. The *Treuhandanstalt* is an independent public body which reports to the Ministry of Finance but is not subordinated to it; it is the sole proprietor of all state-owned capital assets and sole caretaker of assets temporarily placed under state trusteeship. When it comes to divestment, reorganisation or replacement of management, the decisions of the agency cannot (except on formal grounds) be challenged in the courts by the government, the enterprise concerned or individuals affected by the decisions. The "*Treuhand*-model" was also followed by Hungary, but only for a while and with certain limitations.[19] In August 1993 Estonia adopted a similar approach, with the amalgamation of the privatisation ministry and the privatisation agency. The new institution, the Estonia Privatisation Agency, operates under the jurisdiction of the Ministry of Finance. In all other countries, the state and the branch ministries—as founding organs—have preserved their legal ownership rights over existing SOEs and thus the privatisation agency is just one of many government offices. In several Soviet successor states, notably in Russia, but also Lithuania and Georgia, the agency is called a state committee or commission.

The privatisation agencies' disposal rights are usually constrained by upper and lower limits. In Bulgaria, for example, small firms with a book value of less than 10 million leva are privatised by branch ministries, while the disposal of very large SOEs with assets exceeding 200 million leva requires case-by-case approval of the Council of Ministers.[20] In Hungary, state assets below a certain value can be freely divested by the SOE's own management, which allows the agency to concentrate on large transactions.[21] In Croatia, the lower limit is based on asset values expressed in German mark (maximum 5 million). This is understandable given the high level of "dollarization" of that economy. (*Cuckovic* 1992b) Another consideration which

[19] In Hungary, a *Treasury Property Management Office* was created to administer separately property left behind by the Soviet army, the communist party, the workers' militia and the trade unions. The same has happened in the former GDR. Initially, the *Treuhand* agency was responsible for such type of assets as well, but later new organisations were created to take care of them. (See, interview with B. *Breuel* (President of *Treuhandanstalt*) in *Figyelő*, 17 June 1993.)

[20] For details, see the full English-language text of the relevant legislation (Transformation and Privatisation of State-Owned and Municipally-Owned Enterprises Act) in *Bulgarian Economic Review*, 6–19 May 1992.

[21] The threshold varies between 20 and 50 million forint, depending on the circumstances of divestment and the types of asset concerned.

limits the agencies' disposal rights pertains to the branch affiliation of SOEs. The Russian Privatisation Programme for the Year 1992, for example, specifically mentioned that firms in the defence sector could not be privatised without the approval of the Russian government. This is hardly surprising, but given the size and the fluid boundaries of this sector this limitation could have been used to head off privatisation by many thousands of firms. The restriction applied also to firms in the fuel-energy complex, to mining enterprises in general, to commercial banks, foreign trade companies, publishing houses, health resorts, and others.[22] Countries also follow different principles with respect to the size of the privatisation agency. The *Treuhandanstalt* has more than 4,000 employees working in Berlin and 15 regional agencies. Similarly, the Russian privatisation agency, *Goskomimushchestvo*, was conceived as a nationwide organisation with 91 regional offices, staffed by over 10,000 workers; it has its own research institute and runs a newly-established university. (*Radygin and Krasnoselski* 1992) In Hungary, the State Property Agency (SPA) has a staff of 300, and all these work in Budapest; much of its routine work is contracted out to private consulting and auditing firms.[23] After three years of operation, however, the SPA is also considering opening regional offices in 18 locations.[24] In Bulgaria, the agency has a staff of about 120,[25] while in Albania, after almost one year of existence, its counterpart has no more than seven people working in Tirana and another two or three in the provinces.[26]

Size in itself, though not of course decisive, has important implications. The smaller the organisation, the greater the need to delegate responsibilities to outsiders. Typically, these outsiders are the enterprises themselves: they prepare their own privatisation programmes and they negotiate with foreign partners. In other cases, consulting firms are asked to do the same.[27] Both solutions have obvious drawbacks. Enterprise managers and consultants are not independent civil servants; thus they may pursue their own interests and do not have the same degree of accountability as civil servants. The third pillar of the privatisation construct is, in most cases, still in the development phase. Governments or parliaments have concluded that there is a need for special *funds* or *asset management agencies*. These should act as temporary owner-managers of those capital assets which are not yet divested or which are not planned to be privatised in the foreseeable future.

[22]Other types of asset (such as forests, monuments, roads, the central bank, universities, broadcasting stations, etc.) could not be privatised at all. *Ekonomika i zhizn',* No. 29, 1992.

[23]The SPA was established in 1990 with a staff of 56. By 1991, 126 people worked there. In 1992 the number of employees had reached 300 and for 1993 a further 100 people are considered necessary. *PRIVINFO*, Vol. 2, No. 2, January 1993, p. 35.

[24]*Magyar Hírlap*, 7 September 1993.

[25]*Bulgarian Economic Review*, 18 November–1 December 1992.

[26]*Albanian Economic Tribune*, August 1992, pp. 32–33.

[27]In some cases, SOEs are free to choose their advisers (Bulgaria); in other cases advisors are directly appointed by the privatisation agency (Hungary).

The justification for this has been similar everywhere. One institution cannot be made responsible for two types of business activity. Selling assets requires different organisational forms and a different type of staff than the management of assets in large firms, where corporate governance is needed. The fear of corruption has also been quoted as an argument in favour of such systems of dual control.

With the exception of the former GDR, where divestment of most SOEs is planned to be nearly completed by the end of 1993, fund-type institutions are soon likely to emerge in all countries. In some countries a single fund is to be created to own and manage all state assets. So far there is only one case (Croatia), where large numbers of firms have been entrusted to decentralised funds. Such funds are also likely to emerge as an outcome of the voucher privatisation technique (see below). In countries where there is no privatisation agency (e.g., Ukraine), the state asset management fund has become responsible for the preparation and execution of privatisation.

IV. Establishing property rights

Whatever good arguments exist for a three-tier system (privatisation ministry, privatisation agency, asset management fund), it inevitably poses problems of co-ordination. Since there is no clear-cut way of distributing responsibilities among the three tiers, a certain amount of overlapping, departmentalism, and institutional and personal rivalry are probably inescapable.[28] Such risks appear, for example, in the Romanian mass privatisation programme, for which six investment funds have been created. According to their statutes, these companies will become holders, not owners, of assets; it is stipulated that they have to administer the assets on behalf of the population under parliamentary supervision. (*Ionescu* 1992) However, such observations can be made about almost every country.

The situation is potentially more confusing if more than one organisation operates within one level (Ukraine), and/or if the three levels are subordinated to bodies which are in conflict with each other. This appears to be the case in Russia, where *Goskomimushchestvo* is a government-run institution without ownership rights, while the state asset management agency, the ultimate owner, is subordinated to the Supreme Soviet (parliament).[29] As often happens in such situations, a way out of the conflict could be sought by amalgamating the tiers. So far this has

[28] Some countries have taken special note of this risk. When Kazakhstan's Minister for Privatisation was asked in an interview why his country did not have a privatisation agency, he said: "The ministry for privatisation combines both functions. Privatisation would come to a halt if we set up a privatisation agency because there would be a clash between the two". *Central European*, December 1992/January 1993, p. 12.

[29] In October 1993, this body was dissolved by a decree of President Jeltsin and nothing was created to replace it. At the time of writing, it is not clear how this decision will affect the legal position of *Goskomimushchestvo*.

happened in only one country (Croatia), where the privatisation agency and the asset management fund were merged in early 1993. Estonia serves as an example of a different nature. There the ministerial department responsible for privatisation has recently been merged with the privatisation agency. However, it cannot be excluded that, as present governments are replaced, other countries will emulate this example.

Leaving these problems aside, it is still true that over the past two years most countries have taken large steps towards improving the transparency of property rights relations. *First of all*, there has been a need in many countries to designate the state itself as the owner of capital assets inherited from the previous regime and to entrust to it the authority to guide the privatisation process. This is particularly important in those transition economies which are new-born or re-born states. The imposition of *de jure* ownership rights over enterprises, land and other types of tangible asset took considerable time because it had to be preceded by complex inter-state negotiations and legislative work. With the adoption of basic privatisation laws, this process was completed practically everywhere by the end of 1992. (From this generalisation, however, the Russian Federation may have to be excluded, because it has inherited very vague ownership rights from the socialist era. In view of the fact that Russia itself is a federation of 20 autonomous republics and 11 autonomous regions, each of which exerts or at least claims some ownership rights over the assets located on its territories,[30] the process of establishing clear property rights is bound to be protracted. In the successor states of the former Yugoslavia, similar problems are compounded by the heritage of the self-management system, which in a legal sense had been based on the concept of "social ownership". In practice, a solution required the introduction of state ownership prior to privatisation.)

Secondly, the abandonment of central planning necessitated the delegation of ownership rights over vast assets (notably the housing stock) to municipal authorities. Unfortunately, these assets are often in a physically dilapidated shape, or heavily burdened with debt. Indeed, this is one reason why many countries have been unable to move beyond the stage of a political declaration or the passing of a general law on this subject.

It is also worth noting that some governments had planned to endow autonomous public bodies (social security, health and pension funds, charitable organisations, etc.) with property but, except in Croatia, these intensions have so far not been implemented.[31] *Thirdly*, it is generally agreed that "corporatization"

[30] Cities like Moscow or Nizhnii Novgorod have their own privatisation procedures and these differ substantially from the rules set by legislators for Russia as a whole.

[31] In Bulgaria, 20 percent of the shares of privatised enterprises must, according to the Privatisation Law, be transferred to a specially created fund: the State Fund for Reconstruction and Development. The resources of this fund may then be used—*inter alia*—to capitalise the social security fund. In 1991, the Hungarian Parliament passed legislation creating a Social Security

is an important element of the privatisation process, being a means of establishing clear property rights within the state sector.[32] Two extreme cases can be envisaged. One is the conversion of all existing state-owned firms (including agricultural enterprises) into joint stock companies at a very early stage of the privatisation process without any restructuring. Alternatively, it is feasible to postpone changes in the legal form until the appearance of new owners and the adoption of a specific programme of restructuring—and then to consider corporatization as a simple administrative issue. So far, most countries appear in practice to have followed the second option, and the transformation of non-privatised SOEs has therefore been slow.

However, in the former GDR, virtually all *Treuhand*-companies had been transformed into joint stock companies by 1 July 1990.[33] In Romania the transformation also took place early. State enterprises were reorganised into some 7,600 commercial companies (joint stock and limited liability companies), 390 *régies autonomes* and 338 joint-ventures with foreign participation. State commercial companies are all available for privatisation, while the *régies autonomes*—mainly public utilities and strategic industries—are to remain state-owned and subordinated to branch ministries. Even so, these companies may also improve their financial performance by leasing or selling assets. The entire process was virtually completed by the end of 1990. In Czechoslovakia, the corporatization of SOEs was a pre-condition for their inclusion in the voucher privatisation programme. In Croatia and Latvia, laws or government decrees set firm deadlines for the compulsory corporatization of all SOEs—June and November 1992, respectively—but many enterprises were unable to complete the required changes by the date given.[34] Similar deadlines were promulgated in Hungary (December 1992, then prolonged until December 1993) and in Ukraine (June 1993). In Poland, almost 500 companies had been converted by September 1992, and another 1,000 SOEs were expected to undergo corporati-

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and a Pension Fund and endowed it with assets worth Ft 300 billion—an amount equivalent to roughly 15 percent of the total assets suitable for privatisation; however, by mid-1994 legislation had not been implemented. In Poland, the Constitutional Tribunal recently urged the government to propose a scheme by which 18 percent of the shares in firms included in the mass privatisation programme would be set aside in a fund; the aim of the fund is to compensate 3.5 million pensioners and employees who have lost benefits owing to budgetary austerity (*Radio Free Europe/Radio Liberty Research Report*, No. 35, 4 September 1992, p. 37). In Slovenia, 10 percent of shares of all companies must be transferred to the Old Age Pension and Disablement Insurance Fund (*Central European*, February 1993).

[32] The term "corporatization" refers to the change of the firms' legal status from a state agent to a joint stock company, the ownership of which is initially entrusted to a state agency.

[33] The change of legal form was not required for firms that were already earmarked for liquidation, nor for "traditional" state companies such as postal services, the railway system and the administration of public roads and waterways. Firms under the supervision of local and regional authorities were also exempted.

[34] In Croatia, for example, 2,700 SOEs out of 3,900 were reported to have missed the deadline. (EIU 1992)

zation in 1993.[35] In Russia, the end of October 1992 had been fixed as a target date for the corporatization of some 6,000–7,000 SOEs,[36] but later the privatisation agency pushed this deadline back to the end of 1993. However, mandatory corporatization is to apply only to those 4,948 large and medium-sized enterprises which were not exempted from privatisation by the government's 1992 privatisation programme.[37]

V. Commercialisation of large firms

Placing medium-sized and large firms in private hands is obviously the biggest challenge in the transition countries. The different theories offer a plethora of procedures for achieving this goal—especially if mixed solutions are counted separately—and indeed experience shows that virtually all possible privatisation techniques have been tried by one country at least.[38] In this sense, therefore, the picture is fragmented.

Two to three years have been enough to see some common trends emerging. It is quite clear that policies have focused too heavily on the divestment of large state firms, while the possibilities for improving their performance have not been sufficiently explored. Little notice has been taken of the fact that systemic change in itself has already reduced or eliminated many growth-retarding factors: the *nomenklatura* system, the priority treatment of the military sector, and ideological commitments to full employment and CMEA trade. After the removal of these impediments, state-owned companies may have a good chance to improve their performance relative to the past. Leaving these potentials unused is a kind of State desertion:[39] Large SOEs are set adrift in uncharted seas at a time when there is no other ship at close distance which can take tow these unseaworthy large vessels and navigate them into a safe harbour.

In principle, it should be possible to collect enough information about the relative weights of each of the privatisation procedures applied in individual countries and thus arrive at a precise assessment for the region. However, necessary information is lacking, and what is available is often imprecise—chiefly because of confusion over terminology. The same terms appear to be used in different ways even in the same country. Another important reason is that privatisation transac-

[35] Figures are taken from a report by J. *Lewandowski*, Minister of Privatisation (BBC, *Summary of World Broadcasts*, EE/W0263,7 January 1993). At the end of 1992 there were some 7,300 state enterprises as against 8,200 a year earlier.

[36] The modalities were described in a presidential decree issued on 1 July 1992.

[37] BBC, *Summary of World Broadcasts*, SU/W0261,18 December 1992.

[38] For a detailed presentation of these techniques, see U.N. (1992c).

[39] This term is borrowed from *Ábel and Bonin* (1993).

tions at the micro-level represent mixed cases in themselves—a fact which is not objectionable but poses classification problems for the analyst.

Governments in the transition economies are under enormous pressure to show that privatisation in their own country is proceeding swiftly and fully in line with western recommendations. In September 1990, for example, Hungary made headlines with her commitment to divest large SOEs through stock flotations and auctions. This "truly market-conforming" method was highly praised abroad and helped the country to maintain its reform image, in spite of the fact that during the first 15 months not a single deal was completed according to these principles.[40] In a similar way, 1991 and 1992 were the years of the Czechoslovak voucher privatisation, which similarly attracted vivid international attention, although in those two years no ownership change took place by that method. The year 1993 was promised to become the year of the Russian voucher privatisation. What it actually achieved is difficult to say, but the first reactions of western observers were extremely favourable. This was particularly important after reform-minded Acting Prime Minister Gaidar was replaced in late 1992: voucher privatisation was viewed as *the* evidence for the continuation of economic and political reforms.[41]

As shown below in detail, privatisation techniques which are distinctly different on paper can, under the pressure of similar socio-economic circumstances, yield to very similar results.

Perhaps the most obvious procedure for privatising medium-sized and large SOEs is to sell them to *foreign investors* without restructuring of any kind. Two or more birds are thus killed with one stone. The country earns foreign currency, improves its image in the eyes of western governments and the international agencies, while the company concerned is provided with management assistance and capital investment. It is not by chance that the transition economies are promoting this solution and many such deals have been concluded.

To the great disappointment of the transition countries, however, foreign investors appear to have been unwilling to bid for many of the many thousands of SOEs put up for sale. As a sweeping generalisation for the region as a whole, it is probably accurate to state that the demand is sufficiently large in eastern Germany, but that the intensity falls as one moves eastwards. Leaving eastern Germany aside because of the special nature of its "foreign" investors,[42] Hungary

[40] On the failures of the so-called "First Privatisation Programme", see *Voszka* (1992a).

[41] When regular auctions started on 14 January 1993, R.V. *Burke*, deputy director at the office of the US Agency for International Development in Moscow, was quoted on a front page story as saying: "This is far the highest priority the US government has. Everything else depends on getting these big enterprises on a market footing". *International Herald Tribune*, 15 January 1993.

[42] In the period 1 July 1990 to 31 July 1993, foreign investors acquired altogether 732 companies and factories, paying DM 4.9 bn. This is about 10 percent of total sales. See Treuhandanstalt, *Monatsinformation der THA*, 31 July 1993.

has so far provided the most attractive acquisitions in the eyes of western businesses. Yet even there the share of foreign capital in the economy remains fairly modest—around 7 percent according to recent estimates.[43] This shows that this alternative has not led to quick results. Without any detailed investigation, it can safely be said that this is *a fortiori* true for Russia and most successor states of the Soviet Union.

The second equally direct and simple solution is *liquidation*. The company in question is wound up, its assets are sold at scrap value and its name is deleted from all registers, including those of taxpayers. Governments have to solve this very complex dilemma. On the one hand, writing off assets on a mass scale is a very expensive solution for society as a whole. On the other hand, governments are aware that they do not have the means to inject financial or intellectual capital into thousands of ailing firms and—in the absence of a workable industrial policy—they are not even able to know where to start.

In Poland, privatisation through liquidation has, up to now, been a widely pursued practice.[44] Liquidation was originally meant for smaller companies in Poland, while larger ones were expected to go through a transformation procedure. In practice, the liquidation route has become more popular for SOEs of all sizes, as it offers two major advantages over the more formal transformation method.[45] In a liquidation, the assets are directly invested in the new enterprise, while under the transformation procedure, the proceeds of the sale go to the Treasury and not to the enterprise itself. The second advantage relates to the transformation route's requirement that 20 percent of the equity of the new firm must be offered to the employees on preferential terms. This requirement, however, does not hold for liquidated firms. (*Cieslik* 1992)

Liquidation also appears to be a widespread form of privatisation in Moldova, although in this country this is against the law. According to a Russian report such practices are known in all branches of the economy. However, the Ministry of Industry has been the worst hit: 800 collectives have privatised equipment, vehicles and immovable funds worth tens of millions of roubles.[46]

[43] This figure is a weighted average of foreign ownership in the statutory capital of all transformed companies where the state retained 0–100 percent equity. This share should not be confused with the average share of foreign capital in joint ventures arising from the transformation procedure, which is above 30 percent. *Privatizációs Monitor*, April 1994.

[44] In the period 1 January 1990 to November 1992, 1,474 out of 1,955 potentially privatizeable companies have chosen this method. Glówny Urzad Statystyczny, *Informacja o sytuacji spoleczno-gospodarczej kraju w roku 1992*, p. 59.

[45] These two main avenues are often referred to as privatisation according to article 18 (transformation) or article 37 (liquidation) of the Act on the Privatisation of State-Owned Enterprises. For a full English-language text of the law, see U.N. (1992c, pp. 117–130).

[46] Russia's Radio, quoted by BBC, *Summary of World Broadcasts*, SU/1627,3 March 1993.

In Croatia—where large privatisation has so far hardly started—liquidation appears to be one of the favoured solutions, although it has met very strong opposition from the trade unions.[47] Contrary to widespread belief, complete dissolution of companies is a very rare phenomenon in the former GDR. So far, almost 3,000 *Treuhand* companies have been forced into liquidation or bankruptcy, but the process has been completed for only 51 of them.[48]

What is meant by liquidation in some countries is not very different from the changes that are occurring in Hungary under the name *transformation*.[49] Indeed, this avenue has technically been open in Hungary since 1984, but it was hardly used until large SOEs were forced by their rapidly deteriorating financial situation to streamline their organisation structures and break themselves up into smaller, more transparent units. This technique became widespread after 1987, as more and more managers realised that the government was unable to control the process and that legal constraints on asset-stripping were weak and ill-defined. The Transformation Act of 1989 and the creation of the privatisation agency (SPA) in 1990 brought some tightening of state control, but at the same time political changes have given new interpretations of what should be considered as "fair" business practice.

In Hungary, the transformation of companies involves the co-opting of new owners: foreign investors, local authorities (in exchange for the use of land or buildings where the company is located), banks (in debt-equity swap deals), and the workers and managers of the company itself. As the Transformation Act has been flexible enough to accommodate all these claims, it has become the main legal avenue for the privatisation of existing SOEs. By March 1994 around 1000 transformations had been approved by the State Property Agency, and the state holding company, while the remaining 60 SOEs are required to change their legal forms within months.

The privatisation plans in the successor states of the former Yugoslavia are very similar to current Hungarian practice. The only difference is that the blueprints generally define precise proportions among the co-opted new owners, something the Hungarian lawmakers have preferred to leave open for bargaining. In Slovenia, for example, where political and economic conditions are probably most conducive to reform, the privatisation law guarantees a 20 percent share to workers, 20 percent

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[47] In the view of M. Mesic, President of the Confederation of Independent Trade Unions of Croatia, "This model of privatisation brings robbery of the social, worker's and state property unknown in history. (...) First, managers bankrupt a firm in order to make its value low. Then, the managers obtain management loans through banking tricks. (...) This is fake privatisation and criminality of the highest calibre". *Vjesnik*, 18 February 1993, pp. 20–21.

[48] *Treuhandanstalt*, op.cit., 31 July 1993. It is interesting to note that the Treuhand has already set up a subsidiary (*Maschinenhandel T. C. GmBH*) with the sole aim of selling scrapped machinery and equipment.

[49] For an in-depth discussion of the Hungarian privatisation process, see U.N. (1992b, p. 233); Voszka (1992b); *Kiss* (1992).

to investment funds, 10 percent to pension funds and 10 percent to an indemnification fund for the former co-owners.[50] This distribution scheme leaves 40 percent available for sales to domestic or foreign bidders. At the same time, however, an SOE is also allowed to sell its assets in their entirety to a domestic or foreign buyer, provided the buyer makes the required allocations for pension, indemnification and investment funds.[51]

In contrast to the case-by-case operations examined above, more and more countries are contemplating the use of *mass privatisation* methods. In terms of the degree of progress so far, Czechoslovakia, Lithuania, Romania and Russia have taken significant and irreversible steps: in these countries 80–95 percent of those eligible to take part in such schemes have actually bought vouchers or collected them from the distribution points. Similar programmes are in the making in Bulgaria, Hungary, Poland, Slovenia and in virtually all the successor states of the Soviet Union (*Table 2*).

In essence, all these programmes giving away to the population the lion's share of state enterprises. Distinctions should be made, however, between the design of the programmes according to differences in eligibility criteria. In most countries, citizenship and age (18 plus) is the only criterion, but in Estonia, Moldova and Slovenia the number of years in employment is also taken into account. In some countries, notably Estonia and Hungary, two different types of privatisation vouchers are envisaged—one for compensation purposes and another for which all adults are eligible.

Given the large number of countries and the continual changes in the plans themselves, it is not easy to form a comprehensive overview of all programmes. At the risk of over-generalisation, the mass privatisation plans seem to fall into three distinct categories: computerised initial public offerings, the holding concept and direct public auctions.

The computerised initial public offering is an original method launched by the Czechoslovak authorities.[52] In this scheme, individuals bid for shares with voucher points in nationwide computerised auctions. These voucher points are not transferable and bids have to be repeated until a satisfactory level of supply-demand

[50] In contrast to earlier drafts, the late 1992 version of the privatisation law has obtained the blessing of the Slovenian parliament. Implementation of these new laws were scheduled to start in June 1993.

[51] *East European Markets*, 11 December 1992.

[52] The theoretical foundation of this model was laid down by Polish authors. For an English-language work, see *Szomburg and Lewandowski* (1989). As far as implementation in the CSFR is concerned, see U.N. (1992b, pp. 237–238), or the English-language translation of the information handbook prepared by the Czechoslovak Federal Ministry of Finance (*FMF* 1992). For a more up-to-date analysis, see *PlanEcon Report*, Vol. VIII, Nos. 50–52, 25 January 1993 and Vol. IX, Nos. 3–4, 16 February 1993.

Table 2

Voucher privatisation programme in the transition economies

Country	Status	Designation	Law passed	Distribution started	Eligibility	Number of vouchers or "points" per person	Approximate nominal per value
Albania	Planned	–	–	–	Citizens 18+	–	–
Bulgaria	Planned	Privatisation cheque	?	End-93 or early 94	Citizens 18+		Leva 25,000
Czechoslovakia	In progress	Investment coupon (1st wave)	Feb. 91	Oct. 91	Citizens 18+	1,000 points	1 point=35 Kcs
		Investment coupon (2nd wave)	?	Planned	Citizens 18+	1,000 points	1 point=17 Kcs*
Hungary	In progress	Compensation voucher	Jun. 91[a]	Mar. 92	Hungarians including foreign nationals	F(C) Max. Ft 5 mn	–
	In progress	Credit voucher	–	Apr. 94	All citizens	–	
Poland	Planned	Certificate of the National Investment Fund (NIF)	–	–	Citizens 18+	1 share in each of the 20 NIFs	–
Romania	In progress	Certificate of the Private ownership Fund (POF)	Aug. 91	Jun. 92	Citizens 18+	1 share in each of the 5 POFs	1 certificate= Leu 5,000
Slovenia	Planned	Ownership certificates	Dec. 92	–	All citizens	F(E) max. DM 4,000	–
Armenia	Planned	–	–	–	–	–	–
Belarus	Not planned[b]	–	–	–	–	–	–

[a]Similar laws were also passed in April, May and June 1992, enlarging the scope of eligibility.
[b]According to reports reflecting the situation in June 1993.

Table 2 *(continued)*

Voucher privatisation programme in the transition economies

Country	Status	Designation	Law passed	Distri-bution started	Eligibility	Number of vouchers or "points" per person	Approximate nominal per value
Kazakhstan	In process	Voucher	?	Early 1992	All citizens	F(E)	–
Moldova	In progress	National assets bonds	Nov. 92	Apr. 93	All citizens	F(E)+5 years	1 year= coupons
Russia	In progress	Privatisation cheque	Jun. 92	Oct. 92	All citizens	1/person	R10,000
Ukraine	In progress	Privatisation	Mar. 92	–	All citizens	–	30,000 karbovanets
Estonia	In process	Public capital bonds	–	Sep. 91	All citizens	F(E)	1 sq m
	In process	Compensation vouche	–		All citizens	F(C)	housing space
Latvia	Planned	Privatisation accounts	Nov. 92	–	Most residents[c]	F(T)	1/2 sq m housing space
Lithuania	In process	Investment voucher	Feb.91	Feb. 91	All citizens	F(C,A)	Talonas 1–5 thousand (plus inflationary adjustment

[c]Members of the Soviet armed forces, the KGB and high level party functionaries are excluded. For non-citizens five vouchers will be deducted for using the country's infrastructure.

Table 2 *(continued)*

Voucher privatisation programme in the transition economies

Country	Nominal Issue price	Validity	Acceptable as cash for buying	Payment for buying equity in state-created holding companies	Number of medium and large SOEs targeted	Share obtainable through vouchers in any SOEs (percent)	Second-ary trading allowed	Auctions started
Albania	–	–	–	in special funds	–	–	Yes	–
Bulgaria	Leva 9000	–	Shares in firms only	Not yet	500	100	No	–
Czecho-slovakia	Kcs 1,035	10 months	Shares in firms or equity in investment funds	not planned	1,400	15–97	No	May. 92
	Kcs 2–2,500	?	Shares in firms or equity in investment funds	not planned	600–1000*	–	No	–
Hungary	Free	3 years	Land, housing, life annuity, equity	In progress	10–20	0–100	Yes	January 1992
	Ft 2,000	1–2 years	Shops, firms etc.	Not planned	–	49	No	–
Poland	10 percent of monthly wage	4 years	–	In each of the 20 NIFs	600	60	Yes	–
Romania	Free	–	Shops, firms (details unspecified)	In each of the 5 POFs	5,931	30	Yes	–
Slovenia	–	–	–	Planned	–	20	Not decided	–
Armenia	–	–	–	–	–	–	–	–
Belarus	–	–	–	–	–	–	–	–

Table 2 *(continued)*

Voucher privatisation programme in the transition economies

Country	Nominal Issue price	Validity	Acceptable as cash for buying	Payment for buying equity in state-created holding companies	Number of medium and large SOEs targeted	Share obtainable through vouchers in any SOEs (percent)	Secondary trading allowed	Auctions started
Kazakh-stan	Free	–	Housing, firms, etc.	About 20 planned	–	10–15	No	–
Moldova	Free	2 years	Shares	–	–	–	No	Oct. 93
Russia	R25	1 year	Shops, firms, or equity in investment funds, housing, land	Not planned	40,000	35–80	Yes	Jan. 93
Ukraine	Free	2 years	Shops, firms, or equity in investment funds, land (planned)	Planned	–	0–70	No	–
Estonia	Free	4 years	Houses, firms, etc.	Not planned	–	–	After 4 years	Sept.
	Free		Houses, firms, etc.	Not planned	–	–	1991	
Latvia	Free	–	Firms, shops, houses	Not planned	–	–	–	–
Lithuania	Free	–	Houses, shops, land equity in investment funds	Not planned	–	–	Not initially	Sep. 91

Source: Official reports, national newspapers.

Notes: F(C), F(E), F(A), F(T) = Eligibility is a function of the assessed losses under Communist rule (C); Years of employment (E); Age (A); Time lived in the country during the post-war period (T).

equilibrium is achieved: i.e., until the vouchers are used up and all of the firms have found buyers.

Table 3

The scenario of voucher privatization in Czechoslovakia

September 1990	Scenario of economic reform approved by Parliament
26 February 1991	Basic legislation on voucher privatization enacted
1 October 1991–15 February 1992	Registration of coupon books (Czech and Slovak Republics)
First wave	
17 February–27 April 1992	First round of auctions
18 May–8 June 1992	Second round of auctions
8 July–28 July 1992	Third round of auctions
November 1992	Fourth round of auctions
23 November–22 December 1992	Fifth round of auctions
22 December 1992	Completion of first wave
29 March 1993	Start of physical distribution of shares
Second wave	
	(Czech Republic)
Autumn 1993	Registration of coupon books
December 1993	Completion of voucher privatization
No decision yet	(Slovak Republic)

Sources: Press reports.

At the outset, it was envisaged that this method would guarantee a fast solution for the future of 1,500 corporatized SOEs.[53] Progress was considerably slower than expected, in spite of the fact that the so-called "first wave" of bidding was shortened from six to five rounds (*Table 3*). From the conceptual decision in September 1990 it took two and half years to complete the first wave. Investors received their shares during the spring of 1993, and the first meeting of shareholders took place in the summer. Therefore, company restructuring could not have started before the autumn of 1993. From the shareholders' point of view, the time factor was also important, because their choice had been made 12–15 months earlier on the basis of the 1991 balance sheets of the companies concerned. In the meantime, absolute and relative prices changed substantially and the country has been split into two. This latter development means that Czech and Slovak investors now

[53] More precisely, 1,491 SOEs were involved in the first wave, representing all sectors of the economy, including banks. Among the firms, 943 were located in the Czech Republic, 437 in the Slovak Republic and 61 were of a federal nature. On the basis of 1991 data, these firms had a 17 percent share of employment in the Czechoslovak economy. For the second wave less than 1,000 companies have been earmarked.

possess shares in foreign companies, without having a clear idea of future rules concerning cross-border capital transactions and exchange rates.

Another important development was the sudden appearance of privatisation investment funds (*investicní privatizacní fond*) or IPF. An overwhelming majority (72 percent) of Czechoslovak citizens invested their voucher points through these institutions. At the end of the first wave, more than 400 such funds were registered. The nine largest controlled almost 50 percent of all investment points. Of these, six are subsidiaries of well-known Czechoslovak state banks, one belongs to an Austrian bank, one is owned by an American expatriate, and only one is a domestic private venture. Of all voucher points placed, 37 percent are in the hands of the IPFs created by state-owned commercial banks.

The Latvian voucher scheme is a strange mixture of elements of various privatisation techniques. Starting in June 1993, the first batch of 60,000 vouchers were given to those citizens who were "politically repressed" or exiled. It is planned that later the issue of certificates will be done by lots. All in all, the issuing of certificates will go on until the end of 1996 and they will remain valid until the end of 1999. The nominal value of a privatisation voucher has been based on the costs of building half a square metre of living space in a block of flats in 1989. The vouchers themselves are freely tradable, although a heavy tax is imposed on sales. The aim is to encourage holders of vouchers to use them for buying shares in a business or property.[54]

Poland and Romania opted for mass privatisation through closed-end investment funds or *holdings* created by government *fiat*.[55] First, a large number of SOEs were selected (600 in Poland, almost 2,000 in Romania) for inclusion in the programme and converted into share holding companies. In the second step, the shares of these companies were distributed among 5–20 investment funds. Parallel with this process the country's citizens are entitled to buy certificates, representing shares in these holdings, in the expectation of dividends.

As noted above, these certificates have already been distributed in Romania, where progress has also been made in setting up five holdings. One certificate contains five coupons: one coupon for each of the five holdings. The nominal value of the certificates will be announced at a later date. By April 1993, 400 commercial companies, including banks, were allocated to each of the five Private

[54] *The Baltic Independent*, 14–20 May 1993 and BBC, *Summary of World Broadcasts*, SU/1677 1 May 1993.

[55] The origins of the holding model go back to the preparatory discussions of the Hungarian New Economic Mechanism of 1968, when several experts argued for the need to separate ownership rights from disposal rights in order to induce capital flows among SOEs. A proposal to corporatize SOEs, through compulsory transformation into share holding companies was prepared, but it was finally rejected on political grounds and the publication of such ideas was forbidden. For a review of the pre-1968 discussions, see *Hoch* (1991). A few years later, the same suggestion re-emerged in a seminal article by *Tardos* (1972).

Ownership Funds (POF) created on sectoral criteria (i.e. there is a "metallurgy" fund, a "chemical industry fund", etc.). At the same time, this allocation process also aims at a certain territorial balance. POFs are supposed to become regional economic centres. Each POF will be directly involved in the activity of these firms, both in their restructuring and in their privatisation. Recent reports indicate that POFs may be considering the retention of profits for as much as four years in order to finance restructuring investments. Against this background, it is not surprising that so far most "investors" have taken a wait-and-see position. Thus the demand for shares in these funds has been very restrained, while secondary transactions among voucher holders also appears to be marginal.[56]

In Poland, the main political parties are still struggling over different modalities in June 1994. There is no final decision concerning the number of holdings to be created (20 was the figure suggested), nor on the precise list of the approximately 600 SOEs to be involved in the scheme. Laws and Statues relating to the operation of the holdings were also missing.

The latest wave of large privatisation in Russia, which started in December 1992,[57] combines elements from schemes that have already been adopted elsewhere. However, the scheme as a whole is certainly unique and includes untested elements. First of all, divestment of enterprises is envisaged for implementation in the form of *direct public auctions*.[58] Firms on sale by virtue of the law and the decision of the management itself are auctioned directly in a session lasting several hours. There is no computerised bidding or detailed comparison of written documents.

Second, when buying shares in auctions, bidders may pay in cash or with vouchers. Originally, the minimum share of vouchers was set at 25 percent, but this limit was later raised to 80 percent in the case of state-owned firms and to 90 percent in the case of municipally-owned enterprises.[59]

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[56] There is a very thin free market for vouchers, where they sell within the leu 1,500–3,000 range, as opposed to their unofficially suggested face value of leu 30,000. *Heti Világgazdaság*, 13 March 1993.

[57] The pilot auction of shares under the voucher programme was held on 9 December 1992 at the Bolshevik bakery and confectionery plant in Moscow. (*Bush* 1993) However, there have also been reports indicating that in some provinces—e.g. in the Yaroslav Oblast—privatisation vouchers have been exchanged for shares in SOEs, and that this happened as early as October 1992. (Russia's radio, quoted in BBC, *Summary of World Broadcasts*, SU/1509, 12 October 1992.)

[58] Note, however, that the relevant legislation, entitled "State programme for privatisation of state and municipal enterprises in the Russian Federation for 1992" also envisaged the use of such standard methods as closed tenders, liquidation, leasing, etc. For the full text of the law, see *Ekonomika i zhizn'*, No. 29, July 1992, or in English, BBC, *Summary of World Broadcasts*, SU/W0240, 24 July 1992.

[59] This corrective measure was introduced when voucher prices on the secondary market fell to very low levels and the authorities wanted to arrest the fall. Prices on this market were also helped by another announcement of the privatisation agency, hinting that in 1994 large companies with more than 10,000 employees would also be sold off.

Third, in contrast to Czechoslovakia, foreigners can participate openly at the auctions. Given the size of the Russian economy, it is unlikely that foreign investors will carve out a considerable share of it; nevertheless, cherry-picking is, of course, real possibility. This is probably one reason why the list of non-privatizeable enterprises has turned out to be so long from the very outset, and also explains why the entire oil industry was suddenly added to the list later on.[60]

Fourth, Russian vouchers issued with R10,000 nominal face value were made freely tradable immediately on issue. This raises the question of whether vouchers can be regarded as surrogate money and—in the case of a positive answer—whether the privatisation agency was acting legally when it issued them. (*Glusetskii* 1993)

Fifth, as with the privatisation blueprints of the post-Yugoslav states, the Russian scheme is deliberately biased towards protecting the interests of insiders. For those 5,500 medium-sized companies (i.e. with less than 10,000 workers) which were allowed to participate in the 1992 round of auctions, *Goskomimushchestvo* has defined three alternatives, offering a 51 percent stake for management and employees as the maximum (*Table 4*). Prior to, but also after, the enactment of the relevant Supreme Soviet decree, the Russian Fund for the assets of the Federation (the *de jure* owner of all SOEs) waged an active campaign for a fourth alternative, discarded by lawmakers.[61]

Last but not least, an important feature of the Russian scheme is that it allows SOEs to buy vouchers from the public and to use them to acquire partly or fully the outstanding equity remaining on sale after the 51 percent has been purchased by the staff.

This latest wave of privatisation started only recently, so it is too early for any assessment. Some startling sings, however, are visible. The ordinary citizen has often had no idea what to do with the vouchers; thus the immediate reaction has been to sell them for whatever price they would fetch.[62] Up until now the downward trend on the secondary market has been steep. After five months, the price of a R10,000 voucher fell to below R4,000. Other people with more understanding of the rules of the game have opted to deposit their vouchers into one of the 300 investment

[60]According to an Interfax news agency report dated 7 February, *Goskomimushchestvo* sent a telegram to all regional branches instructing them to stop accepting and approving privatisation applications in the oil and oil-refining industries. BBC, *Summary of World Broadcasts*, SU/1608, 9 February 1993.

[61]However, a motion to include Variant 4 among the options remained on the agenda of the Supreme Soviet, which was supposed to approve the 1993 privatisation programme. *Izvestiya*, 19 February 1993.

[62]According to a public opinion poll carried out in October 1992, 58 percent of respondents were not interested in investing their vouchers and most of them planned to sell them for cash. Only 15 percent wanted to buy additional vouchers. The potential buyer tended to be under 25, male, and in a good private- or state-sector job. Interest in buying vouchers was also markedly higher among high earners. *Radio Free Europe/Radio Liberty Research Report*, Vol. 1, No. 48, 4 December 1992.

Table 4

Methods of privatisation in Russia for medium-sized enterprises

Variant	Preferred (non-voting) shares		Common shares	
	General rule	Constraint	General rule	Constraint
1	Free to all employees up to 25 percent of charter capital	One employee cannot receive more than 20 times the minimum wage	Employees can buy shares up to 10 percent of the charter capital with a payment period of 3 years and a 30 percent discount	Down-payment minimum 15 percent
			and	
			Chief officials have an option to buy shares up to 5 percent of character capital at nominal price	One official cannot buy more than 2,000 times the minimum wage
2	–	–	All workers can buy shares up to 51 percent of charter capital at nominal price	–
3	–	–	A group of employees can buy shares up to 20 percent of charter capital with 30 percent discount	The firm has to be privatized in a year
			and	
			Employees can buy shares up to 20 percent of charter capital with 30 percent discount	
4	–	–	Employees can buy shares up to 90 percent of charter capital with 30 percent discount in a payment period of 3–5 years	–

Source: State Programme for Privatisation of State and Municipal Enterprises in the Russian Federation for 1992; newspaper reports.
Note: Variants 1–3 from the State Programme, Variant 4 is from newspaper reports. See also text for explanation.

funds, as in Czechoslovakia.[63] In the Russian case, however, the inherent risk of this avenue has manifested itself at a very early stage. The first reported case of fraud by an investment fund occurred in St. Petersburg, inflicting losses of more than R3 billion to thousands of citizens.[64] By mid-February 1993 only a few dozed voucher auctions had been held. It seems that two thirds of the selected SOEs have chosen Version 2, which guarantees a 51 percent stake to the working collective, albeit without any discount. This is understandable. Since the law was adopted in mid-1992, the purchasing power of the vouchers has increased enormously, because asset valuation is based on 1991 bookkeeping values. Thus, price has become virtually irrelevant for the first 51 percent of shares allotted to workers without auction. According to analysts, there is a tendency for the management and staff of firms put up for auction to aim at acquiring 90 or 100 percent ownership, as was envisaged by the proponents of the so-called "fourth alternative". They hire brokerage firms to buy up the required number of vouchers and, when it comes to bidding, these insiders can easily squeeze out other investors.[65]

VI. The new owners

Following this review of privatisation practices in eastern Europe and the countries of the former Soviet Union, one important question remains to be answered: who are the new owners of privatised state assets?

One answer can be easily discarded. It is mistaken to believe that foreigners are the main players. Existing provisions generally restrict the sale of land to foreign individuals or enterprises. By and large, the same is true for the housing stock. Foreigners have wider access to assets divested in the service sector, but so far their interest has proved to be relatively limited in most east European countries and, *a fortiori*, in the CIS states. Large privatisation is still in its initial phase in most countries, so no firm conclusions can yet be drawn. On the whole, there are signs of a certain foreign interest, but after corporatization the lion's share of assets has fallen firmly into the hands of domestic firms, including the various state asset management funds.[66]

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[63] By July 1993, 50 percent of the population was reported to have opted for this strategy. *Moscow News*, 23 July 1993.

[64] The private investment fund in question had offered the following deal: in exchange for every voucher deposited, it promised to pay R12,000 per month and pledged to give back the vouchers without notice at the owner's request. For the first month, the fund honoured its commitments, after the second it declared bankruptcy and its managers disappeared with 300,000 vouchers. Three thousand aggrieved clients demonstrated on the streets of St. Petersburg demanding stricter regulations and better control. For the full details, see *Izvestiya*, 13 February 1993.

[65] *Finansovye Izvestiya*, 4–10 February 1993.

[66] It is worth noting, however, that both the Czechoslovak and the Russian voucher privatisation programmes have opened the door for foreign investors to buy stakes in the privatisation funds and

It is more difficult to discard a second claim frequently met, namely that the new owners are essentially representatives of the old *nomenklatura*, supplemented by criminals and adventurers.[67] Once again, this allegation is obviously groundless in the case of land, housing and service workshops. The sheer size of the asset stock proves that there is a much larger circle of people involved in the privatisation process. None the less, there is probably some element of truth in these assertions when it comes to large privatisation. It is certainly true that, prior to 1989, there was virtually no possibility of accumulating significant private wealth—in other words, starting capital—in any of the countries concerned. For this reason, the concentration of private wealth does give rise to questions. It is also undeniable that crime—including organised crime—is on the increase everywhere and that it is possible, indeed likely, that there is no strong barrier between the world of organised crime and the world of business.[68] On the other hand, it should not be forgotten that the turbulent changes of the past 3–4 years have opened numerous legal avenues to enrichment, starting from street trading to foreign exchange and real estate transactions. As markets have gradually been liberalised, risk-taking entrepreneurs have had ample opportunities to find activities where extra profits could be earned without transgressing any legal barrier. Restitution may bring riches overnight and—at least in eastern Europe and the Baltic countries—there is a significant inflow of private capital arising from the return of the *Diaspora*.

But beyond this general comment, it should be noted that the privatisation process is driven by far more complex motives than ownership alone. In those cases where a large SOE is split into 10–15 smaller units, new executive positions open up. When foreign partners are involved, this holds out prospects of increased travel possibilities, access to state-of-the-art technologies, etc. After the political changes in late 1989, successful SOE managers could aim at positions in the new state administration or at better paid jobs with western firms. In addition to these possibilities, the establishment of hundreds of joint stock companies has created new types of management positions.

The second problem with the view which sees the inherited old regime behind every change is that it fails to put the issue in the right historical and cultural

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thus obtain property rights in large SOEs without lengthy negotiations with company directors and the state authorities. However, there is no way of knowing to what extent foreign investors have actually exploited this possibility.

[67] For a passionate exposition of this view, see the article by G. *Popov*, the prominent Russian economist and former mayor of Moscow, in *Moscow News*, 18 February 1993.

[68] This issue appears to be particularly grave in Russia and perhaps in some other CIS republics. Addressing an all-Russia conference on the problems of combating organised crime and corruption, President Yeltsin estimated that "over half the criminal groups have corrupt links. Bribes for obtaining licences and the allocation of quotas, for the granting of credits at privileged rates, for creating special conditions for commercial structures, for acquiring at reduced prices state property which is being privatised and many other things—all of this is the reality of our life". BBC, *Summary of World Broadcasts*, SU/1613, 15 February 1993.

context. In the transition economies, there are few people available with sufficient technical and commercial competence to do a better job than the previous management cadres. After the fundamental changes that have taken place in these countries' political systems, it has proved easier to find a certain number of qualified intellectuals who are ready to assume political and government functions in the new framework. However, there is no back-up for the thousands or tens of thousands of managers and officials running the existing SOEs and the state machinery. This is a much broader circle than the *nomenklatura*—i.e officials whose appointments in the past were directly controlled by the central party apparatus.[69] Independent experts can, of course, be invited from abroad, but this is not a cheap solution and very often these "foreigners" are in fact expatriates themselves, so their independence can also be questioned.[70] Experience has shown that the increase in objectivity they bring is not sufficient to outweigh their lack of detailed knowledge. Western accounting firms appear to have a particularly poor record in this respect. In Hungary, for example, their involvement in the privatisation process has been limited to rubber-stamping after Hungarian accountants have done the real job. This problem has arisen in a very direct manner in Poland too, where the planned state investment funds were supposed to be headed by foreigners. Given the obvious language requirements, external recruitment is basically limited to expatriates.

Without an in-depth analysis on a case-by-case basis, it is very difficult to arrive at an impartial assessment. In one country, the state authorities are deeply dissatisfied with the conduct of the management running the corporatized firms and have tried to slow down privatisation in order to restore discipline and control.[71] In another country, a similar situation is often interpreted as evidence against the government, which wants nothing else but to spread itself out through the agency

[69] After the communist takeovers in the respective countries after the Second World War, nationalisation campaigns went along with a ruthless removal of previous management. Qualified engineers and businessmen were sacked (if not arrested) and reliable party workers were put in their place. In terms of lost efficiency, the price of this policy was enormous. Today, this lesson is still very much in the memories of the decision-makers in many countries, and they are trying hard not to repeat the same mistakes.

[70] For example, in Estonia, the head of the privatisation agency was removed because he was accused of breaching impartiality in favour of the country in which he grew up. Similar doubts were raised in Hungary when the government nominated an American citizen as the head of the state holding company. After 8 months this person was forced to resign, once it became public that he was paid from American public sources.

[71] This appears to be the case in Romania, as the following quotation of President *Iliescu* indicates: "We have very many companies whose leadership survives because of their popularity. Certainly, I do not want to say what kind of business deals are made, but they are anything but clean, since any kind of contract relations have disappeared; thus all these control instruments have disappeared; there are independent people who have complete freedom—it is they who are the owners, not the state. (...) These people manage the assets of the given enterprises but they are not the owners of the social capital which belongs to the state." BBC, *Summary of World Broadcasts*, EE/1544, 21 November 1992.

of the enterprises—directly or indirectly through the newly created state asset management funds—in order to size their revenues and to fill the bottomless pits of the Treasury.[72]

It should be noted that in critical areas, private entrepreneurship is developing on the basis of leaseholds (in agriculture and retail trade), where the right of use and *de jure* ownership are not in the same hands. In the sphere of medium-sized and large SOEs, corporatization and privatisation have given rise to various forms of *cross-ownership*. Due to the overall economic depression prevailing in the transition economies, the newly-transformed companies are forced to look for unconventional sources of financing. As a means of avoiding bankruptcy, they seek ownership links with their creditors (state-owned banks in most cases) or their suppliers, which may or may not be in private hands. In other cases, subsidiaries and production units are sold or leased to outsiders. The rise of financial intermediaries (holdings) has had a similar impact. Many Czechoslovak investment funds, for example, were originally created by commercial banks, which in turn are partly owned by enterprises.

Finally, note should be taken of the fact that privatisation schemes are often designed to give preferential treatment to the workforce and the management (ESOP, management buy-out). This is a prime characteristic of the Russian privatisation programme, but it frequently occurs in the former GDR, in Hungary and Poland as well.

From a budgetary point of view, large privatisation has yielded relatively small revenues. This was, of course, intentional in the case of the mass privatisation programmes, but it was certainly not envisaged in Germany or Hungary.

At the time of unification it was believed that east German assets were worth over DM 600 billion. In autumn 1992, when publishing the audit of the 8,500 firms on its books (reflecting the situation it was in July 1990) the *Treuhand* estimated their net worth as a *negative* DM 200 billion.[73] By 31 January 1993 revenues from privatisation amounted to a mere DM 41 billion.[74] The costs of restructuring—in the form of debt relief, environmental and employee compensation—which all appear on the expenditure side of the *Treuhands* budget, are much larger than anybody expected. According to current estimates, when the *Treuhand* winds up its activities in 1994, instead of contributing to the German state budget it will leave a DM 300 billion debt.

[72] For example, this is how the eminent Croatian economist Branko *Horvat* assesses the situation in his country: "Privatisation ought to be stopped momentarily and the government must stay out if it. Instead the Parliament ought to form a commission of independent, internationally renowned experts that should take look after the implementation of the reform." (*Vjesnik*, 3 March 1993.) For a similar view, see Cuckovic (1992a).

[73] More precisely, the total 1990 value of 8,400 economic units was estimated at DM 311 billion, as opposed to a debt burden of DM 521 bn. *Frankfurter Allgemeine Zeitung*, 16 October 1992.

[74] *Treuhandanstalt*, op.cit., p. 12.

In Hungary, the balance sheet of the two privatisation agencies is less transparent. On the one hand, there are fairly detailed reports on the revenue side, according to which more than Ft 300 billion ($1.3 billion) was cashed in between 1991 and early 1994. However, there is virtually no information about the true cost implications of the approved transformations.[75] Companies were often sold to foreign investors with multi-year tax privileges, but these items were not reflected in the balance sheets. Thus, it is impossible to state whether any net revenue from privatisation has materialised in Hungary. However, there is a strong possibility that there will be hardly any when the whole process is completed sometime in the late 1990s.

VII. The size of the private sector

Structural changes are difficult to measure in any case, but the task is even more demanding when it comes to measuring something as fundamental as ownership rights.

In the east, statistics on the size of the private sector are subject to a number of biases and deficiencies for historical reasons. Moreover, statisticians are at times under pressure to produce numbers showing a high share of the private sector in GDP, employment or in the capital stock. At the same time, however, the changes in statistical reporting systems and data collection rules are still under way, and many small enterprises are probably still escaping the official statistical net. Inadequate tax collection systems and strong incentives to avoid or reduce tax liabilities are another reason for incomplete coverage of the new private sector.

It might also be noted that the propagation of business-like behaviour is not necessarily measured by the extension of majority private ownership. In the transition countries there are important examples—such as the Czech car producer Skoda or the previously quoted Hungarian example, the VIDEOTON factory—where private (including foreign) owners are in a minority. None the less, these companies act under a hard budget constraint and behave like truly private business entities. Obviously, contrary examples could also be cited.

The generic growth of the private sector should also be taken into consideration. Privatisation is unfolding against a backdrop of mushrooming new ventures, green field foreign direct investment and the appearance of hundreds of thousands of small, non-incorporated businesses. Although a large majority of these new

[75] One of the rare examples when both pluses and minuses were reported was the case of the country's largest television manufacturer VIDEOTON. To the state, liquidating the firm cost Ft 20–30 billion in the form of unpaid debt. To the new owners it cost a mere Ft 4 billion and "many nice promises". (Voszka 1992c)

initiatives have some roots in the old production structures, statistically the connections are hardly identifiable. For this reason the process is sometimes labelled as "hidden privatisation", which is an apt characterisation of its essentials. This practice appears to be rather widespread in the sphere of business services, where former state employees are creating their own private ventures with a minimum of fixed assets, and are trying to make their living by capitalising on their personal business connections and market knowledge. The other side of the coin, of course, is that a state-owned enterprise deprived of its intellectual capital is likely to slide into bankruptcy soon, and its remaining assets are taken over at bargain prices by outsiders—perhaps by the very same people who ran the enterprise before.

Given these factors, any attempt to quantify the distribution of ownership rights on a nationwide level is very approximate at best (*Table 5*). In the case of mixed ownership which as shown above, occurs rather frequently, there is no unambiguous method of deciding which company should be termed private and which state-owned. *Table 5* is essentially based on information provided by the national statistical authorities of a few east European countries and Russia. From a methodological point of view, it is interesting to note that the Hungarian authorities are working with three different sets of numbers. Two sets of estimates, produced independently by the Ministry of Finance and the privatisation agency, attempt to sort out private and non-private firms on the basis of tax returns. The third series, reported by the country's central statistical office, is based on the size of the workforce. It is assumed that size thresholds can be established—not necessarily uniform throughout the economy—below which firms are unlikely to be state-owned. Obviously, both methods are imperfect and only experience will show which will be more suitable for the purposes of measurement.

VIII. Outlook

Slow progress in privatisation reflects the ponderous heritage from the past—four decades in the case of eastern Europe and seven decades in the case of the successor states of the Soviet Union—which cannot be regarded as a closed chapter. Vested interests, deeply-established forms of thinking, legal traditions and informal connections do not disappear overnight. This tension between the heritage from the past and the move towards a democratic consensus will be mitigated and probably overcome as the democratic process moves forward—but all this needs a lot of time.

The list of open questions is fairly long. Here only the three most salient ones can be mentioned. *First*, restitution and compensation cause delays and create obstacles to privatisation as well as to new private business developments. *Second*, there is no mechanism in place to ensure adequate corporate governance of those

Table 5

Official estimates of the contribution of the private sector to GDP (percentages)

	1988	1989	1990	1991	1992
Bulgaria (1)	–	–	–	5	10
Bulgaria (2)	–	–	–	–	14
Czechoslovakia	–	4.1	5.2	9.3	–
Czech Republic	–	–	–	–	20
Slovak Republic	–	–	–	–	20–21[a]
Hungary (1)	–	–	10.0	27.0	35
Hungary (2)	–	–	–	41.0	45
Hungary (3)	14.3	14.9	15.8	18.2	25
Poland	–	28.6	30.9	42.1	45–50
Romania	–	–	–	–	26
Russia	–	–	–	–	6.7[b]
Yugoslavian FR	–	–	–	40[c]	–

[a]Contribution to national income.
[b]Contribution to industrial output in the January–October period.
[c]Includes cooperatives and enterprises in mixed ownership.

Sources: Official statistics, unless indicated otherwise. *Bulgaria (1)*: Statement of President Zhelev, as quoted in BBC, Summary of World Broadcasts, EE/1577, 4 January 1993; *Bulgaria (2)* Country note of the Government of Bulgaria, presented at an UNCTAD Ad Hoc Working Group on Comparative Experience with Privatisation, 7–11 June 1993, Geneva; CSFR: FSU Bulletin 1992, No. 5, p. A34; *Czech Republic*: Rudé Pravo, 20 February 1993; *Slovak Republic*: Slovenského Statistického ęradu, Bulletin No. 12. 1992. p. 2; *Hungary (1)*: Ministry of Finance, Economic Policy 1993–94, Budapest, 1992, p. 3 (1989–1991), B. Kádár (Minister of International Economic Relations) in Magyar Hírlap, 23 January 1993; *Hungary (2)*: Estimates of the State Property Agency. Hungarian Review, Vol. 2. No. 12, 29 March 1993; *Hungary (3)*: CSO data. Share of small enterprises, including economic activites of households. National Accounts—Hungary 1988–1991 Budapest, February 1993, p. 17, 1992 data from "Gazdasági-társadalmi áttekintés az 1992. évről" (An economic and social assessment of the year 1992). Statisztikai Hírek (undated); *Poland*: Rocznik Statystyczny 1992, p. xiii, 1992 data from the press conference of Deputy Prime Minister H. Goryszewski, held on 20 January 1993, as reported in BBC, Summary of World Broadcasts, EE/1594, 23 January 1993; *Romania*: Buletin de Informare Publica No. 12. 1992; *Russia*: O razvitii ekonomicheskikh reform v Rossiiskoi Feredatsii v Janvare–Octobre 1992 goda, p. 138.

enterprises which, for one reason or another, remain in state ownership. There is no shortage of determined statements,[76] but there is much less action. The same

[76]For example, speaking about state property which remains in state ownership, Deputy Minister and Chairman of *Goskomimushchestvo* A. Chubays said the following on Russian television: "(it should be subject) to strict, extremely strict, dictatorial state control over the effective use of that state property, no matter what ideas there are about full economic management or anything like that. State property with state control, with the appointment of the director, with the state

question can be also raised with respect to the emerging financial intermediaries, the holdings or investment funds. There is a potential danger that they could become vehicles of state intervention, especially in those countries where they are led by government-appointed officials. The *third* problem is that privatisation in many countries is viewed with increasing discomfort and anger by the electorate and the population at large. The fear of crime and the identification of privatisation with theft is a palpable (and sometimes not an entirely groundless) sentiment.

All in all, the balance is positive. In the context of overall systemic changes, privatisation has already become irreversible in the entire region. True, the path of privatisation followed so far has been different from the one envisaged by parliamentarians, governments and academic experts. Yet this is nothing to be astonished by. The scene has changed and will doubtlessly continue to evolve in a promising direction: away from central planning and closer to a market-based, democratic system.

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THE REVIVAL OF REDISTRIBUTION IN HUNGARY

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Politicians and analysts, businessmen and citizens generally agree that economic transformation should amount to the creation of a market economy. Paradoxically enough, the gradual establishment of the basic institutions of the market, including private ownership, stands in contrast to signs that another integration mechanism is being reactivated: namely, redistribution. Following a temporary withdrawal in the late 1980s and the very beginning of the 1980s, the direct redistributive function of the state seems to have gained new vigour.

Redistribution[1] was started by the government when it centralized ownership rights: in the earlier economic reforms these had been delegated to enterprise managements. The last step of decentralization was made in the mid-eighties, when enterprise councils (set up from representatives of the management and employees) were authorized to exercise most ownership rights, including the appointment of enterprise managers, to make decisions on mergers and acquisitions, and to establish companies with state assets. From 1990 on, several dozen enterprises were taken under direct administrative control one by one, and this process was followed by the enactment of mandatory corporatization in 1992. Direct state control and corporatization mean the removal of enterprise councils and the assignment of all ownership rights to the State Property Agency (SPA): i.e. to the central privatization organization controlled by and reporting to the government.

Thus corporatization, which was to be completed by the end of 1993, can be identified as a form of "renationalization".[2] According to Polányi's definition, this in itself amounts to redistribution, i.e. the collecting of controlling rights. The question is, to what extent will central authorities be able or willing to utilize their new position, or, in other words: will formal centralization be followed by the redistribution of company positions and incomes or not?

This question is not easy to answer. The redistribution process is still less transparent and more difficult to quantify than before due to the fact that it is in its initial stages and due to the new methods it uses (which do not result in direct budgetary expenditure). Therefore the extension of redistribution cannot

[1] Following the definition proposed by Károly *Polányi* (1976) and generally used in the evaluation of a planned economy, the term "redistribution" means the central pooling and redistribution of rights and goods. This definition is limited here to the redistribution of enterprise positions and incomes.

[2] For more detail, see *Sárközy* (1993) and *Voszka* (1993). Renationalization is used here in quotation marks, because the form studied below means the reallocation of controlling rights inside the framework of state ownership. The term renationalization will also appear in its original meaning.

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be characterized by macro-economic data alone. Instead of defining the share of redistribution and drawing final conclusions, this paper rather tries to outline some typical phenomena and formulate hypotheses for a future empirical study.

Old and new methods

The methods will be analyzed with a focus on showing those of their redistributive effects that are often not evident. We will try to outline their scope of application, the financial consequences, and to reveal the underlying reasons and motivations. It will be shown that most of the new features which come under the headings of reorganization, debt consolidation and market protection fall in the category of redistribution.

Special policies

The traditional forms of redistribution of enterprise positions like replacement of the management and changing the organization frameworks, have also been used in the state-owned enterprise (SOE) sector in recent years. The preconditions of these steps were created by the corporatization of SOEs enabling the SPA instead of the enterprise councils to make any decisions relating to mergers, the splitting up of an enterprise, or on the appointment of new managers.

Changing the guard. It is not only the position and opportunities of the persons concerned, but that of the enterprises that might be directly affected by the replacement of managements and the appointment of a board and supervisory board members in the commercialized enterprises. On the one hand, new managers enjoying the confidence of the state owner can contribute to the stabilization of the firm's position using their good political or business contacts, and thus they can acquire additional resources or preferential treatment. On the other hand, employees often perceive the new unknown managers as actual threats to their vital interests; this has been demonstrated on several occasions, and has also included strikes.

Statistical data are not available about the overall range of management replacements, except the data published by the SPA for the year 1992. According to them, 72 chief executives were fired from 126 enterprises that were taken under administrative control. 12 cases were recorded in companies after corporatization and before privatization. Replacements concerned several big firms like the national oil company, the Hungarian airlines and several pharmaceutical enterprises. In some sectors such as printing or state farms, most firms were reached by the wave of management change. In 1992, the SPA assigned some 5000 people as Board members or Supervisory Committee members of commercial enterprises (*Government of the Republic of Hungary* 1993).

The SPA explained most replacements by referring to the acceleration of the privatization process or the prevention of the loss of state assets. These are soft categories. Without any clear-cut evaluation criteria that are transparent for everyone concerned, all managers are threatened continuously and have good reason to feel that "anything can happen". In a climate of overall and incalculable threat, managers are preoccupied with attempts to show loyalty, to present a "positive attitude", and to try to find out the values and intentions of the bureaucracies. In such circumstances it is difficult to disprove the general belief about the direct political influences in connection with the appointment of managers and board members.

Changing the organizational frameworks. Mergers and the splitting up of firms have always meant the redistribution of enterprise positions and future opportunities. In the last few years, however, some of these actions have also entailed direct income redistribution in the form of compulsory purchasing of another company's assets, or they have served as complementary subsidies.

Crisis management of SOEs by the merger of autonomous firms was a well-known method in planned economies. Such measures in Hungary were rare in the eighties, but began to reappear in the early nineties.

The "integration" of coal mines and electrical power plants is one of the most widely known examples. This merger was motivated by the loss-making and imminent bankruptcy of the mines. The government intended to overcome the financial and market problems by vertical integration, merging the strong supplier/customer relations (and thus reducing constant disagreements) into one organization. The aim was to establish a system of direct control and transfer prices. As a result, the acquired firms would get a chance to survive, even though they are now complaining about the loss of their independence. Budgetary subsidies are substituted by draining the resources of the acquired units, while the firms get into the position of controlling shareholder).

The splitting up of big SOEs into smaller units was a more widespread approach after organizational decentralization was declared as a priority in the revised privatization policy of 1992 (see the document *Privatization strategy task team* 1992). According to this document, the main goal of privatization is the creation of a wide, strong proprietary middle-class in Hungary. The new policy requires the modification of both the demand and supply side. The proposed instruments for increasing domestic demand for state assets include preferential loans, ESOP and privatization leasing constructions, as well as the so-called "credit notes". An adequate supply structure is to be created by organizational restructuring: i.e. by splitting up large units.

From the company point of view, the traditional form of decentralization deriving from a central initiative is perceived as a hostile administrative decision; it is seen to result in cuts in the company's capacities, market shares and negotiating powers against business partners or government bodies—and all this without any compensation. (This type of splitting up has so far concerned mainly the food industry and retail trade. Well-known examples include many cases of small priva-

tization, the grocery networks in Budapest and in Northern and Southern Hungary as well as the baking industry.)

In the 1990s a new type of organizational decentralization occurred in Hungary. This splitting up, rescuing the SOEs, typically means the sale of property, factories or plants upon the initiative (or at least with the approval) of the large SOEs, but with the consent of the SPA. Incomes from these deals are recycled to the remaining units to consolidate their financial position and mainly to repay their debts. According to experts, most of the recent decentralizations fall into this category.

The result of this process is similar to the "asset stripping" for which spontaneous privatization used to be blamed. It is an important difference, however, that this time the final decision is made by government bodies. The permission to sell units and the granting of the incomes to the SOEs can be regarded as an individual preference for them, while the privatization incomes of the SPA are significantly reduced by these measures.[3]

Income redistribution. The redistribution of financial resources between SOEs appeared in different forms in the 1990s, even occurring independently of organizational changes.

The process started in the industrial sector. The dramatic reduction in budgetary subsidies at the turn of the 1980s and 1990s coincided with the shrinking of the market due to the loss of most COMECON contracts and the sudden sharpening of import competition. According to the Ministry of Industry and Trade (1991), forty percent of industrial firms became loss-makers. In line with the general depression, the growing pressure of regions specially badly affected by the crisis, and the attempt to stabilize its own position, the Ministry of Industry and Trade (MINIT) declared the new policy of "getting closer to the enterprises". It claimed that "the state must not withdraw from its own property and the ministry has to deal with operative matters" (*Kovács* 1991).

As a first step late in 1991, the industrial administration tried to address the regional crises. By that time the draft of a comprehensive industrial policy had been prepared. Its tools included state guarantees, preferential credit rates, cancelling of debts, debt to equity swaps and other subventions. This was the first time the ministry had published a plan to investigate the positions of forty big SOEs.

The governmental management of enterprise crises started in 1991 with some exceptional, individual decisions. Two early cases that were causing great concern included coal mining and metallurgy in Ózd and Diósgyőr. The fate of these firms

[3] There is no registration of the incomes recycled to the SOEs. One of the SPA directors, however, estimated the amount of this "reorganization fund" to be equal to the official privatization proceeds (i.e. about HUF 130 billion between 1990 and July 1993).

involved indicates that the measures did not amount to more than "fire fighting". They were followed by mass demonstrations, strikes or other trade union actions. While several billion forints were spent on these sectors, the amounts could do no more than offer provisional and marginal relief to the firms concerned.

SOEs were kept in a state of uncertainty by the incalculable behaviour of the government, but it did not seem hopeless for them to try to get subsidies all over again. The institutionalization of redistribution was supposed to remove the uncertainty and, at the same time, to set frameworks for enterprise bargaining.

Attempts at creating a formal system of redistribution

The "Big Thirteen". The creation of a formal system (i.e. institutionalization) of financial redistribution started with special treatment for thirteen firms. According to a government resolution[4] these enterprises were short-listed on the basis of the criteria outlined below. Their operation "on a competitive basis is of national economic interest and the prevention of their liquidation is supported by industrial policy considerations", such as giving them significant weight in exports and in regional employment or safeguarding certain professional cultures. From this larger group, central assistance covers firms producing competitive products or that are able to change markets, at least in the long run. An additional argument said that the state would not actually suffer any real loss: the repayment of debts was an unlikely prospect anyway.

MINIT initially studied the special treatment of forty organizations. This list was reduced, not according to competitive potentials, but rather according to the characteristics of indebtedness. The government could help the firms which were indebted directly to the state (i.e. they were not indebted to suppliers or commercial banks).

The total asset value of the selected thirteen firms was assessed at nearly HUF 150 bn. and their total debts at HUF 56 bn. (These figures do not include supplier credits in the range of another HUF 25 or 30 bn.). The SOEs involved more than 80 thousand people employed. Their turnover plan for 1992 was HUF 230 bn.

According to MINIT (1993), the debts of seven companies were cancelled, rescheduled or swapped, and altogether this totalled HUF 11.1 bn. For some members of the group, HUF 3.1 bn. of new credit was underwritten by the state. From privatization incomes HUF 4.3 bn. was allocated to reorganization and HUF 3.5 bn. custom duties and tax debts were cancelled. Nearly half of the total cost of more than HUF 22 bn. was received by one firm.

[4] Government resolution No. 3298/1992. For the detailed history of the "Big Thirteen", see *Karsai* (1993).

Typically, the methods applied have not directly increased current budgetary expenditure, although they do imply lost revenue and deferred burdens. From the point of view of the companies concerned the special treatment has meant individual preferences, and an opportunity to solve the acute liquidity problems. Nevertheless, even according to the MINIT evaluation (1993), the programme has achieved only partial success, measured by the number of rescued companies, by the amount of the assets or people concerned[5] as well as by the stability of results. "It is true ... for each firm, that the long-term improvement of their position depends largely on the successful debt consolidation and the accompanying reorganization process, implemented in due time." In other words, crisis management, again, was not more than "fire fighting", even in the most successful cases. It brought some temporary financial relief, without any structural adjustment.

Crisis management even in this limited sense proved to be unsuccessful where debts did not directly concern the state. Commercial banks could be put under informal pressure for some time by either the government or the companies. Leading state owned commercial banks rarely initiated any liquidation process[6] while they kept rolling out the loans to key debtors. (Therefore, for example, the credits of the Big Thirteen were not recorded as "non-performing".) Due partly to the "permissive" banking attitude, partly to the poor inherited portfolios allocated to the banks at the time of their creation in 1987, and partly to uncertainty and recession which equally hindered credit rating and repayment, the capital structure and the liquidity position of leading banks were steadily eroded.[7] This is why the process of debt consolidation was launched.

Debt consolidation. The actions of the state in 1992 targetted the improvement of the yearly balance sheets of banks[8] by cleaning the portfolios and by swapping the bad debts to government bonds. The first round included a package of HUF 102 bn. face value and HUF 80 bn. swap. This in itself amounts to redistribution because the interest on government bonds is paid from the state budget. Redistribution has occurred not only in favour of the bank sector but also between banks. The highest gains were achieved by those who had accumulated more bad

[5] "Crisis management was successful in the case of eight companies and the position of one firm was improved as a result of earlier measures", MINIT writes. Looking behind the number of SOEs, the rates seem even worse. According to the calculations based on MIT data, only one third of the assets and employees of the "Thirteen" was rescued.

[6] In 1992, the year of the big bankruptcy and liquidation wave, only about 80 proceedings were initiated by banks, representing less than one percent of all cases.

[7] Moreover, the new laws on banking and accounting, enacted in 1992, introduced much more rigorous international standards. This in itself worsened the positions of banks, or, more precisely, brought to the surface the hidden problems.

[8] At the beginning, consolidation concerned banks in which the state had a majority interest. In the process of 1993, 11 banks were involved, including banks of mixed ownership.

debts without building up adequate reserves, because they could now get rid of their non-performing loans cheaply.

It was clear already from the moment the above decision was made, that if nothing else were to change, then another substantial amount of the total debts would slip down to the non-performing category by 1993.[9] It was also predictable that even the benefits of the banks would be devalued by the consolidation fees to be paid by them and the low interest rate of the government bonds. By international auditing standards, no appreciable improvement was achieved in capital adequacy ratios.

Due to the above reasons, it was clear to each actor that consolidation would not remain an opportunity that would last forever. The 1993 plans focused on raising the bank capital. The position of the banks was improved by swapping bonds for higher coupon rate bonds and by abolishing the debt consolidation fees (although these measures worsened the position of the state budget). Moreover, the amount to be invested in order to achieve an at least temporary acceptable capital adequacy ratio[10] was estimated at nearly HUF 80 bn. The raising of capital obviously meant additional burdens on the budget, and it may also involve rearranging the relative positions by eliminating the existing differences in former performances. This step also modified the ownership structure by reducing the weight of the actual shareholders (mainly SOEs, if not foreigners), and considerably increasing the share of the state.

All these measures still did not change the position of the indebted firms. In 1993 the notion of "debt consolidation" was split into two branches of a narrower "bank consolidation" and the new "debtor consolidation". One of the main issues of debates on the governmental level concerned the question: what kind of organization should manage the consolidated enterprise debts? (The solution initiated in 1992, the predominant role of a new state organization, the Hungarian Investment and Development Co., proved to be unviable.) According to recent proposals, firms having bad loans in the consolidated banks may apply to participate in debtor consolidation.[11] They have to prepare reorganization plans that are evaluated first by a special inter-departmental committee, and afterwards by the lending bank itself.

According to preliminary estimates, debtor consolidation may concern about thirty thousand loan agreements, most of which involve private companies and not state-owned ones. More than half (2300 out of 4000) of the loan agreements entered into the consolidation process in 1992 were executed by private firms. The amount of these credits has not been published. The series

[9] As a result of consolidation in 1992, the amount of bad debts decreased by HUF 100 bn. to increase by HUF 30 bn. in the first half of 1993, while the total qualified debts increased by more than double this sum.

[10] This capital adequacy ratio was set at 4 percent. The achievement of international standards would require an additional investment of HUF 140 bn.

[11] That is, "bad" debtors of "good" banks are excluded from consolidation.

of failures of private business (which was considered to be sound until quite recently) however, explains the growing importance of this sector from the banks' point of view.

As a consequence of consolidation, government bonds (issued to the amount of HUF 300 bn. by the end of 1993) have increased state debts and the interest has increased current budgetary expenditure. In return, the balance sheets of the banks involved in consolidation have temporarily improved. Beside this, the intricate financial manoeuvres have resulted in renationalization—and this time literally, not like the case of compulsory corporatization; in 1993 the share of the state in the banks increased.[12] Thus, the state is restoring its decision-making sovereignty above banks and their debtors. By removing the disinterest of banks in cancelling or rescheduling the debts, the government has eliminated the obstacles which have hindered the financial restructuring of the Big Thirteen. Through debtor consolidation, concerning several thousand firms, the bank consolidation process has gradually turned into a comprehensive reorganization programme, involving a major part of the economy.

Guarantees. Bank consolidation has the backward effect of mitigating the risks resulting from bad debts. There are accepted forms of risk mitigation in market economies, involving guarantees that the expected burdens parallel with making a loan contract will be shared. Underwriting by the state has been more and more widely used in Hungary, too.

According to the Ministry of Finance (1993a), a total of HUF 4.3 bn. including HUF 3.6 bn. enterprise credit was guaranteed in 1992 by the state budget. By May 1993, state guarantee was almost as high as the total application in 1992. Moreover, the list presented by the Ministry is far from complete. It does not include the sum of HUF 3.1 bn. made available to the "Big Thirteen" nor other items each in the range of several billion forints made available to coal mines and other corporations. The guarantees made by other government authorities are to be added to these amounts. According to the report of the National Auditors, HUF 24 bn. was underwritten by SPA by the end of 1992, and the amount was nearly doubled by mid-1993 (*Nagy* 1993).

The individual cases were gradually followed by institutionalized arrangements. Underwriting Co., an organization in which the state has a majority interest, started its activities in early 1993. Its objective is to support the credit rating of private businesses which are able to promise high return rates but cannot meet the collateral requirements of commercial banks. The company guarantees up to 80 percent or HUF 100 million of commercial bank loans. Underwriting Co. is backed by the Small Business Guarantee Fund. This is financed from the central budget. This financial construction offers guarantees up to 70 percent of the amount guar-

[12] According to the most recent proposals at the time of writing, the extended ownership rights of the state will be exercised not only by the present shareholder of the banks, i.e., by the State Holding Company, but also by the Ministry of Finance, because of budgetary investments. The Ministry wants to control 75 percent of voting shares until the end of 1995, when the debt consolidation agreements will be terminated.

anteed by Underwriting Co. This means that the greater part of the risk is directly borne by the state.

Until December 1993, Underwriting Co. guaranteed HUF 3.7 bn. for HUF 6.6 bn. credit. More than half of this debt was raised under the highly preferential Existence Loan scheme. About a third of the proposals were disqualified, mainly because of unacceptable business plans (*Veres* 1993).

If the borrower fails (a likelihood estimated by experts officially at 30 percent but informally even at 60 percent), the assets offered as collateral are transferred to the shared ownership of the commercial banks and Underwriting Co. In the short run this means renationalization, just like many other forms of state support.

The second important terrain for establishing the formal system of underwriting by the state has been the Export Guarantee Co., set up in 1991. The expansion of its operation and the method of state participation in the export financing system was the subject of discussion (Ministry of Finance, 1993b). Unlike Underwriting Co., loans linked to export should be available for big transactions. Considering the market problems of large enterprises, this method may tend to finance sales where the buyer is more or less clearly insolvent.[13] Thus, the export guarantee may become a market building tool of the state, with consequences similar to the Comecon trade as far as the production pattern and payment processes are concerned.

State guarantee may be crucial for enterprises, especially if they need borrowed funds to finance the raw materials or components need for production. Thus the position of a company is directly influenced by obtaining guarantees in a process of case by case state decisions. If the borrowers fail to pay, the central budget meets their liabilities, which means income redistribution. Thus, state guarantee may become a new and increasingly popular method of redistribution. It fits in with those tools of redistribution whereby the budgetary expenditure is postponed and deficit financing is transferred to future governments. The crucial question here is, of course, the number of underwriting claims.

In the last few years this type of budgetary expenditure has not been more than ten billion Forints. Experts of the Ministry of Finance expected the same order of magnitude for 1993. Up till Autumn 1993, the SPA as an underwriter had paid out HUF 8.7 bn., which was more than half of its underwriting liabilities. Its expenditures for guarantees are estimated at HUF 15 bn. for 1994 (Asset Policy Guidelines 1993). If the amount of guarantees keeps climbing as it actually does at the moment and more and more organizations are unable to meet their liabilities in a lingering recession, then the burdens of the state budget will steadily grow.

Formalized systems are double-edged swords in general, and also in the particular case of state guarantees. A formal system can establish standard processes and thus control the scope of bargaining. (This is one of the most important and overt objectives of the Ministry of Finance in transforming the export guarantee system.) On the other hand, institutionalization establishes a forum for bargains

[13] The 1992 Russian wheat export may be quoted here as a warning example. A 100 million dollar guarantee had to be called by the lending bank.

and suggests to all market actors that there is a chance to obtain preferences. Thus institutionalization may have the effect of escalating the processes instead of controlling them.

Escalation of redistribution

The time dimensions of all this have already been indicated by the aforesaid. It was gradually realized that the methods used for consolidation in 1992 and 1993 were not going to achieve any long-term, "final" solution. The partial portfolio cleaning was insufficient for bank consolidation, while the mitigation of direct indebtedness to the state was insufficient for reorganizing the big SOEs.[14] The government was insistent when it declared that 1993 would be the last year of consolidation. However, the parties concerned consider this statement to be more of a wish than reality, and not without good reasons.

Many analysts agree that this proliferation follows from the nature of the problems. Namely, it is not one group of banks or firms, but the entire economy which is in a crisis situation. Successful treatment would mean the creation of a healthy economy. Yet such a huge and dynamic problem cannot be addressed by partial and static tools.

Beside its spread over time, the escalation of redistribution to a wider and wider group of companies has also been striking. The initial exceptional cases have been followed by institutionalization. The special treatment of 13 firms ended up with proposals to rescue 40 large companies, as originally proposed by the Ministry of Industry and Trade. If such measures were to be taken in industry, why leave out food processing or the agricultural sector as a whole? Of course, the Ministry of Agriculture came up with a comprehensive programme of restructuring. If there is help for sectors there must also be help for depressed regions. In 1993 the government approved a detailed project to manage the crisis situation of two countries in North Hungary.

It has been noticed before that state support may also be expected by private firms. The agricultural sector was the first to make a public suggestion private farmers should be allowed to bid for the consolidation of their debts if their debt to equity ratio is higher than 25 percent. The proposing ministry was also aware of creating a precedent for the conversion of private debts into state ones. Nevertheless, in late 1993 it was a generally accepted idea that the debtor consolidation process should be extended to private business, irrespective of their field of operations.

[14] It is not hard to predict that the passive treatment concentrating on existing credit burdens will soon turn out to be insufficient. Like the banking sector, the firms will also need fresh capital to cover their losses and to modernize their production systems.

The private sector should not be discriminated against—it is the main reason for supporting this approach. However, there is an argument that, the promotion of private business having been supported in the period of planned economy, the extension of state subsidies should take place to promote nationalization. From the point of view of the entrepreneurship concerned, accepting this principle means no less than enterprise without risk, by courtesy of the taxpayers. Bank experts already claim that having heard the news about cancelling or rescheduling debts, even those debtors who can pay avoid doing so.

Private firms—mainly well-known international investors—are the pioneers of extension protectionism. In addition to privileged competitive positions, the preferences can also mean that the capital is raised by the state or there is access to preferential funds.

An expert of the Ministry of International Economic Relations (MIER) said that "Multies" are just as keen to obtain privileges as Hungarian companies and they also expect the state to play a considerable role in economic decisions. This is also supported by the comments of companies. According to a manager of a big joint venture, "we are much more concerned about the matters of the ministry than our customers". The importance of this approach is illustrated by the fact that many joint ventures with foreign participation hired Hungarian managers with a professional background in large SOEs, or experience in the former administration. In this way they used people who had wide-spread personal contacts and good skills in informal bargaining.

The volume of investment, employment or export are key arguments connected with the pressure coming from (foreign) private firms, too. This reasoning is often accompanied by threats such as substitution of domestic suppliers by import and close production either temporarily or for good.

The Association of International Companies in Hungary was established in 1992 by 14 Multies. They initiated an offensive strategy in the form of a "dialogue" with the government. At negotiations held about taxation, employment or industrial policy they, too, claimed that they had invested more than 100 bn. HUF in Hungary and employed about 25,000 people. Suzuki, for instance, asked the state to raise capital first for its suppliers and then for itself, quoting that after coming on full stream in 1995 its production would reach 5 to 6 percent of GDP. The plain to curb or stop production was first raised in General Electric-Tungsram and in the paper industry.

Most preferences, including the control of international trade, involve the central redistribution of enterprise positions, irrespective of the claims of major international investors concerning the overall economic benefits of their successful negotiations with the government.

The conflicts between organizations operating in the same business and at different points of the vertical system are direct manifestations of the redistributing effect. Higher customs duty and the restriction of import volumes are obvious benefits for domestic producers, while punishing the importers. The selective reduction of customs duty means a disadvantage for competitors interested in imports. Conflicts are further escalated by relations with international organizations. This was made clear recently by the termination of the two-year term of payment of the customs duty on TV sets. According to an MIER expert the customs duty cannot be increased unless a compensation is offered to key partners in the process of GATT negotiations; that is, if customs of other items are reduced according to their preferences. Likewise, the limit fixed at 15 percent on EC imports means that—say—the entire steel producing sector can be protected, but no other industry. In other words, any preference of a sector or a product might be given to the detriment of others.

To sum up, most of the international investors holding strong negotiating positions, and having seen the growing willingness of the government to help, tend to apply for preferences and to achieve individual or group subsidies just like the "big socialist enterprises". While in the case of these joint ventures with foreign participation the products are not *ab ovo* unmarketable and the companies are not hopeless cases, the income earned on the markets available is obviously not enough for profitable operation. Thus, foreign entrepreneurs do not always bring in a market style business culture to the Hungarian economy. Instead, for quite understandable reasons, they are taking the path of least resistance, adapting themselves to the prevailing business culture of milking the state budget.

This form of redistribution also tends to bring about the escalation of privileges. While the extent of such an escalation is limited by international contracts, especially in foreign trade, the preference for joint ventures elicits due criticism from domestic firms and provides a basis of reference for them to also request privileges. Escalation in the significance of the time factor is indicated among other things by the important argument of foreign investors claiming that the business environment has changed since the time of planning or making their investments. If changing conditions, however, are considered to be a sufficient ground for getting preferences, it will be hard to stop the cascade.

Traditional redistribution or a new model?

The recent redistribution has many features that can be compared with the model of the preceding decades, as well as several other new characteristics. First, the specific micro-level decisions defining company positions are made by central authorities (Parliament, government or inter-ministerial committees), just like before. Sub-centres of redistribution also continue to exist. In this group, the role of branch ministries is being taken over by organizations representing the state as owner (like the SPA). These organizations have developed the old ministry attitude in the representation of company interests.

Second, as far as the methods and criteria of decision-making are concerned, the old approach of central selection and negotiations by individual companies or groups of companies continues to persist. Decision-makers try harder to consider the competitive potential of a business or a product. While this evaluation can now be based on safer grounds, taking into account the judgment of the global market, the key criteria continue to include the size of the company (volume of production, sales or employment) and its monopolistic position.

Third, the tools for central restructuring include the traditional methods of changing the organizational structure and the financial position of the firms. Direct budgetary subsidies are overruled, however, by new forms, characterized rather by

loss of income, postponed expenses and increased state debts, rather than by current budgetary expenditure.

Fourth, preferences were given to state-owned enterprises (and commercial banks) at the beginning. Several large SOEs, however, were left to their own devices, while their rescued group was swollen by foreign investors and domestic private entrepreneurs. This obviously reflects the shift of bargaining potential and negotiating positions within the company sector.

Thus redistribution appears on several levels, following the ownership structure. The first level includes the rescuing of SOEs, where the government acts simultaneously as an owner and a regulator of the market. On the second level the government only appears in the role of regulator, granting preferences to fully or majority privately owned firms. The third level, not covered by this paper, includes the allocation of state-owned assets where the state does not perform a direct regulatory function but distributes its assets to preferred strata or institutions free of charge.

If central redistribution of company positions and incomes is not limited to state ownership, it means that privatization in itself does not put an end to state redistribution. It has to be added, however, that there are several interfaces between the transformation process of the ownership structure and redistribution.

One of these connections is the tendency of renationalization, as it is understood in both senses of the term used in the paper (expansion of state ownership and centralization of ownership rights in state-controlled areas). Any form of renationalization opens the way for the distribution of assets—that is, for using privatization methods other than sale. On the other hand, if distribution means the streamlining of privatization, then companies have to be restructured first. An ailing company with heavy debt burdens is not accepted, even as a present! In the case of a sale with substantial preferences—granted to foreign investors, or more recently to domestic ones—the dependency on state support is likely to revive in the operation of these private firms.

It is clear that the pressure of firms plays a crucial role in the expansion of state redistribution. This pressure is due to the loss of markets, the strengthening of competition, the inherited or newly amassed debts and growing costs, including high interest rates and taxes. The government's attitude is also understandable. Ideological commitments or direct political election objectives are not the only point, their doubtless implications notwithstanding. Beside these factors, state intervention is prompted by the domino effect of the bankruptcy law, the continuous dwindling of production and exports, the upsetting of the external financial equilibrium, and the regional concentration of unemployment.

It is for these reasons that the key question does not concern the advantages of redistribution for the state or the firms. Paradoxically, four years after the collapse of planned economy, we have to go back to the old question of the reform economists: what are the disadvantages of central redistribution?

The costs of realizing the benefits must be paid in strict economic terms, including the preservation of a non-competitive production structure, the surge of the budget deficit and foreign debts, as well as growing inflation. Since the unfavourable effects on equilibrium can be delayed but not eliminated, a redistribution spiral may be unleashed. Costs will be financed, among others things, by growing taxes that undermine still further entrepreneurship, and simultaneously increase the need for subsidies and the reduction of funds available for distribution.

A still higher price has to be paid for the short-term relief of redistribution in terms of a distorted orientation of the firms and of the economic mechanism as a whole. Companies, including private firms, try to obtain governmental preferences in order to overcome their market problems. This leads to laziness and the reproduction of disequilibriums and the restoration of the soft budget constraint—characteristic for the planned economy—with all its implications (*Kornai* 1980). This approach is anti-competition because the entry of new actors is hindered by the advantages of others and by non-transparent rules and regulations. It is also anti-consumer because it limits choices by keeping prices and taxes high, in order to cover the costs of redistribution.

The undesirable implications of redistribution and the mechanisms supporting its proliferation must be taken into account, even if the redistribution of company positions and incomes cannot be considered the single or even a decisive feature of the economy. There is no homogeneous integration mechanism in the recent Hungarian economy. The lack of such a unified system, however, does not disguise the simple formula where state ownership and private ownership are perfectly separated and operate along quite different models. There is no standard integration mechanism even within the different ownership groups. Undoubtedly, there is a competitive market operating in several segments of the economy; however, private firms (especially the big foreign investors) demand privileges from the state. As for the future, the degree of difference between the old and new model of redistribution in terms of motivations and effects is a critical question. Is it possible for two integration mechanisms of conflicting logic to coexist in the long run? What is the pattern of a mixed economy which sets out from the economic and sociological traditions of redistribution, and which is a mixed system not only from the point of view of ownership but also within the bounds of the companies—irrespective of their proprietary structure? Does it fit in any widespread economic model or do we, as has already been suggested,[15] have to reckon with the emergence of a new economic model in Hungary and Eastern Europe?

[15] For more details see *Stark* (1993).

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ITS CODE-NAME IS FINANCIAL REORGANISATION
(How to handle the corporate crisis?)

J. KARSAI

A special trait of Hungarian financial reorganisation is that there are no for-profit, private firms that specialize in this activity, there is a lack of capital, and it is not linked to the privatisation of the firms concerned. The state's options under the present high budget deficit are to cancel past debts, to sever dependence on certain kinds of income (mainly that from privatization), and to assure guarantees for the future. Although this might be enough to prolong the struggle for important firms it cannot improve the prospects for the whole of the economy. The study was written in Summer 1993, i.e. before the enacting of the bank reorganisation and debt consolidation programme adopted in December 1993. First experiences with reorganisation financed from the budget seem to corroborate the statements of the study.

In the last two years any citizen reading the Hungarian press would frequently have met the latest pet term of economic policy: financial reorganisation. Government, corporate and banking people invariably think it will solve the problems of crisis-ridden firms. Naturally enough it is—as it is generally the case—a term broad enough to allow different interpretations. Although the original meaning of the term would suggest conformity with market methods, in reality the idea behind it is to save firms without having to privatize them—or to put it less strongly, to put them on a firm financial footing before privatisation. This policy is contrary to the spirit of competition and private property that are so necessary for the transition to a market economy.

Today in Hungary reorganisation in fact involves defensive tactics that do not really serve the market-based resurrection of viable firms, but rather the extension of the life of ailing firms that have no real prospects of success. At present in Hungary there is not enough capital and there are no organisations for this activity. As a result of the defensive character of reorganisation, or more precisely due to haphazard resurrection methods that are really substitutes for clear policy conceptions, the efforts of government organs are not focused on abolishing the above-mentioned lacunae. Instead they try to expand their conflict-resolving activities and, consequently, their own influence. The efficiency of all this is dubious, considering that for want of capital one cannot speak about financial reorganisation however noble or ignoble its objectives are.

For a long time there has been a rumour about the possible participation of international financial organisations in the process of financial reorganisation in Hungary. There is still no agreement on this. Even the inflow of foreign direct capital has subsided. This might perhaps have something to do with Hungarian

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economic policy, the contradictory domestic acceptance of foreign capital and the general outlook of the Hungarian economy.

The government tries to make up for the lack of capital by methods that put a burden on the budget and add to the domestic government debt (i.e. by cancelling debts and other dues, by rescheduling credits, and by pledging guarantees). These are methods which confuse its roles as proprietor and macroeconomic manager, as was the case in the past. The easing of present tensions is done at the expense of the future; however, if this is not done to serve an acceptable objective, it means giving our future as a hostage to fortune.

The "dirty" thirteen

In 1991, in reports about firms with serious problems, those firms whose fate was decided by the Ministry of Industry and Trade (and included in the crisis management programme for 1992) were overrepresented. This programme offered special treatment for 13 state-owned firms. The ministry wanted to avoid the liquidation of these firms, which it deemed so important for industrial policy; in effect, it was thereby preserving certain industrial cultures and jobs for 80 thousand people. Official declarations asserted that these firms would be able to switch markets and to increase exports. However, size of the task was demonstrated by the fact that the debt of these firms to the government and to commercial banks was Fts 80–90 billion (*K.Z.* 1993).

In the event, the thirteen firms—most of them loss-making and some under liquidation—did not obtain the money mentioned in the original plans and the method of assistance was also different from that which the firms expected. (*-LER* 1993). The money assigned by the government and approved by Parliament did not mean new capital for these firms. This was because the government—for want of finances—was only able to help by renouncing its claims on future income which was due to it; thus the nature of the "aid" was not what was expected. Under the crisis-management programme rent on state-owned assets amounting to Fts 7 billion was cancelled and credits were also cancelled, while Fts 300 million of the debt total were rescheduled. Part of the programme was thus a debt-to-equity swap, and for the 13 firms this meant a further reduction of rent payment to the value of Fts 3 billion and of credit repayment totalling Fts 2 billion (*Magos* 1993).

The limits to the whole campaign were already inherent in the selection of firms. The most important criteria were not the existence of markets and the ability to function profitable but the assumed importance of the firms for the national economy, their assumed strategic value, and the avoidance of employment problems.

As a result of this crisis-management method, the action was only successful in the cases of those firms which were mainly in debt to the state and not towards

commercial banks or suppliers. The idea of transforming indebtedness to commercial banks into shares could not be realized due to the resistance of the banks.

At the time of writing another decision of the government tried again to help the 13 selected firms: it suggested to banks that it would bear responsibility for 90 percent of the face value of the total debts of 12 of the 13 firms. The government would pay with government bonds and the debt would be offered for sale to the State Property Agency, the State Property Management Corporation and the Hungarian Investment and Development Corporation. Thus the budget would be burdened only by the difference between the purchase and sale price (*Merényi* 1993).

Beside this, the government would guarantee these "preferred" firms when rescheduling their debts, and also—albeit to a lesser extent—when they took new credits. (All in all this assistance meant more than Fts 3 billion to the firms, and it should be noted that not all of them participated). Within the state guarantees offered over the last two years these selected firms were clearly overrepresented (*Czelnai* 1993).

These forms of assistance, namely the renouncing by the government of several years of budgetary income, do not in fact burden the budget at the moment of their granting. They make it possible for the state to "reschedule" financial tensions by using methods of crisis management which are at the expense of the future.[1]

Under a separate formula more than Fts 3 billion were given by the government to some of the 13 firms gained from privatisation.

The campaign to save the 13 firms is supplemented (by most of the firms) with protectionist measures that are intended to improve their competitive edge vis-à-vis subsidized East-European competitors. Government orders are also a big assistance to the firms concerned.

The complex package for aiding the 13 firms has only brought partial results. Of the 13 firms, which had for years been assisted due to their assumed importance for the national economy, eight were at the time of writing in a balanced position, one improved its situation as a result of former measures, and for four firms the above-mentioned forms of assistance were not enough to solve their respective crises (K.Z. 1993).

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[1] Impressed by the "success" of the Ministry of Industry and Trade, the Ministry of Agriculture also developed a crisis management programme for ten selected firms. The programme offered almost Fts 10 billion for crisis management and was initially accepted by the government. The ministry hopes that the action will improve the possibilities of privatisation in the firms concerned. The objective with agricultural firms is first of all to abolish the chronic shortage of working capital. Its methods are: offering guarantees, credit rescheduling, the writing off of debts to the government, and the giving of new credits to fill the capital fund. As it has turned out, since the "acceptance declaration" of the government the sequencing of firms has been based on the intensity of the chain reaction elicited by them. All the ten firms should be helped up to the end of 1993 (*Életmentés* ...1993).

In reality, however, even the eight firms that appear to have been put in order are not on a track which guarantees their future profitability. There is a danger that central assistance has in fact provided no more than a temporary solution for them, and it is likely that within a few years their problems will reappear. The privatization of these firms—which would make renewal for them possible—has not made any substantial progress. This fact contradicts the widely held opinion that rundown Hungarian firms should be put in order with government means and participation before being privatized.[2]

This conception has not been successful in the case of the most important 13 firms, despite the serious efforts that have been made. This should be enough to prevent similar failures in the case of the several hundred government firms due for privatisation.

According to mid-May 1993 conceptions a new method of reorganization involving government assistance will be tried. The so-called "reorganisation bond" issued by strategically important industrial firms is intended to make it possible for the firms that issue such bonds to obtain the means for financing their reorganisation at a much cheaper cost than if they were to have recourse to the credit market. The bond would have a three year maturity, guaranteed by the state, and a 20 percent yield. It would be offered to small investors, investment funds, and perhaps foreign strategic investors. Two or three firms planned to issue bonds worth of Fts 2–3 billion in 1993. In mid-July of 1993, while this paper was being finished, it was already known that in addition to the 13 firms mentioned above some other strategic firms were to be included in the programme (*Kurucz* 1993b).[3] It can be seen that the above—"new"—method of assistance rely on state guarantees. The "phasing out" of the burden of the budget, and subjective points of view should also have an impact.[4]

[2] There is an opinion that in the case of healthy firms privatization is not a must, since the state can spend the dividend obtained from them on the amelioration of other firms. However, in effect this would halt the process of transition to a market economy.

[3] A similar security, the so-called "liquidation equity" will first be used in a meat processing firm which could not be saved despite Fts 1 billion worth of government guarantee. Fts 400 million worth of equity will be issued with 3 percent interest and 2 percent premium. A guarantee will be given by the SPA, the HIDB (Hungarian Investment and Development Bank), and a commercial bank (*P.Á.G.* 1993).

[4] The Ministry of Agriculture has progressed further in its programme of reorganisation through equity than has the Ministry of Industry. In July 1993 it started a common project with the EBRD. Under this programme 14–15 highly indebted meat processing firms capable of producing exports will be given the right to issue equity. The equity will be taken by the EBRD at face value and the firms will be able to use the money interest-free for three years (*Cz. V.* 1993).

The sweethearts of the State Property Agency

The State Property Agency (SPA) is a government institution which controls that part of the for-profit assets of the state which might be privatized without legal constraint. This refers to more than one thousand firms. With the slowing down of privatization—the most effective method of improving rundown firms—there is pressure on the SPA to find other methods of crisis management.

Since the SPA cannot offer its "rundown" firms at a price commensurate with their present state without evoking the charge of "selling out" the country, it has introduced several privatization methods which make cheap credit available for domestic purchasers.[5] However, purchase with credit might have a deleterious effect on firms in difficult situations, because it could result in the outflow of capital desperately needed for their successful operation.

The SPA has thus tried, beside privatisation, other methods of putting firms in order. One of them has been the selling of individual parts of a firm due for reorganization, leaving the revenue from such sales with the mother firm (*Jelentés* ...1993). Thus, by sacrificing a small part of assets given for reorganisation, this solution replaces outright budget outlay with income fallout; this is characteristic of the above-mentioned crisis-management methods of the Ministry of Industry.

The procedure by which the SPA draws firms which are in difficulty under direct government control cannot be classed as true crisis management. It is really only an administrative step even if the SPA (by training and nominating crisis managers) is trying to assist the management of firms under control.

A certain leeway for the preferences of the SPA, and thus for the selective rescue of firms in difficulties, is provided by the special fund created for such purposes from privatization income. In 1993 it amounted—according to the Asset Management Directives—to Fts 5 billion. Another possibility is that it can assume guarantees for credit-taking and the issue of bonds by individual firms, in a similar way to the budget. At the time of writing, the present guarantee had been pledged by the SPA for credit worth Fts 8,5 billion, and 40 percent of this total had to be paid in cash (*K.G.* 1993). (The preferences of the SPA are demonstrated by the fact that it opted to support the agreed bankruptcy of a firm employing 2000 people and with dubious market prospects instead of shouldering part of the credits of a really efficient firm that was about to be privatized; as a result the latter was forced into liquidation.)[6]

[5] Among such methods we find the ESOP or the leasing construction.

[6] According to the deputy head of the board of directors of the SPA, it has no money to assume part of the credits of indebted firms that have been deemed able to produce export quality. Thus these firms cannot be privatized despite the fact that there are professional investors ready to pay cash and raise capital (*Karsai G.* 1993a).

The SPA, having sensed the financial constraints it faces, will try in 1994 to spend a higher share of its income on the pre-sale reorganisation of the firms for which it is responsible. Therefore it "cherishes" the plans for a fund which would give instant aid to prospective firms, and would thereby avoid bankruptcy and liquidation (*Átalakul* ...1993). Another ambitious plan of the SPA is to create "holding structures" for firms that are at present unsaleable. The management of such structures would be financially interested in the reorganisation of firms for which they are responsible and which are for sale (*Czibor* 1993). The first step of the reorganisation package would be the creation of a holding of 12 firms, using USD 20 million of EBRD and PHARE assistance (*Kurcz* 1993c).

The reorganisation plans of the SPA are aimed at a few selected firms. The sources for these plans are primarily from that part of the privatization income which is not paid into the budget, as well as assistance from international organisations. However, it is not clear that the SPA-holding will be interested in selling the firms after their reorganisation.

The firms protected by the "government" corporation

The State Asset Managing Corporation (SAMC) controls in a corporate form 160 state-owned firms, and it has a more significant role in reorganisation than the SPA. Although it can—at least up to its part of share ownership—privatize the firms for which it is responsible, its main task is to improve the firms. This is demonstrated by the statement of the first president of the SAMC, which declared "the stabilisation of the economy requires not privatisation at all costs but well-conceived asset management and the improvement of potentially competitive firms" (*Bossányi* 1993).

"Putting firms in order" is not taking place exclusively on the basis of market considerations since the proprietory rights of the SAMC are acted out by following the policy decisions of the government (Karsai G. 1993). An important sign of the contradiction between government expectations and economic rationality is that the government has acquired the ownership of firms that have been reorganised after liquidation. Under normal circumstances this might have been an irrational step on the part of the SAMC, but under government decree it was compelled to buy certain defence industry firms in order to maintain the property share of the government.

The SAMC would like to obtain for its reorganisation programme (as well as other tasks) the capital allotted to it by law, since in mid-May 1993 it was still waiting for Fts 2 billion despite the inclusion of this amount in the Asset Management Directives of 1992. According to the draft of the 1993 Asset Management Directives "the SAMC spends Fts 51 billion on reorganisation investment and re-

newal of tools of production, whereas the financial burden of credit rescheduling will be Fts 34 billion" (Vagyonpolitikai ...1993). The source of this large amount is not indicated in the document.

In order to ease somewhat the acute financial problems of some SAMC firms the SAMC had, up to mid-May 1993, provided full guarantees to the amount of Fts 6 billion (Karsai, G. 1993b).

Along with its own resources the SAMC has tried to secure the capital needed for its operation by issuing bonds and entering, albeit with small steps, the domestic and foreign bond markets (N. *Vadász* 1993).

Originally the SAMC was given a key role by the government in financing the reorganisation programmes assisted by international organisations. (The corporation was more suitable for this task than a government organ because of its legal status).[7] It is no wonder, therefore, that the reorganisation programmes of the SAMC were originally attached to industry-wide projects by the EBRD, the European Community and the World Bank. In the meantime, however, the whole USD 1.5 billion programme has been transferred from the authority of the SAMC to that of the secretary of state responsible for privatization (Bossányi 1993). As yet, the effect of this on the SAMC has not been felt.

Up to mid-May 1993, the SAMC as a proprietor has not allowed its firms to go bankrupt, but it envisages that later on liquidation or merger will have to be implemented for non-viable ones. Market-based selection between firms will also be limited in the future by proprietory considerations of the state; this will, of necessity, prevail in reorganisation activity until stronger financial basis is achieved.

The clients of the investment bank

Another important participant of reorganisation under state influence is the state-owned corporation which has obtained a licence for banking activities. This organisation was created on the basis of an old idea (which could not be applied in the past due to a lack of finances) according to which the reorganisation of firms important for the national economy might be accomplished on a for-profit basis. Although the financing of a reorganisation holding capable of such a task would be in accord with the original intentions shared with foreign money owners, the Hungarian government later had to withdraw due to a lack of interest; however, one result of this was that, at the end of 1991, the Hungarian Investment and Development Corporation (HIDC) was set up as an independent organization. The

[7] Despite the better "pedigree" of the State Asset Managing Corporation it should not be forgotten that this is a typical "state" corporation where the rights of the general assembly are acted out by the Minister of Privatisation and the members of the board of directors, and members of the supervisory committee are nominated by the Prime Minister (*Sárközy* 1993).

SPA and the State Development Institute (SDI) (representing the state and the National Lottery Corporation, a minority government property) were the founders. The base capital they could afford was somewhat meagre with regard to the tasks involved. For the for-profit financing of state investments the HIDC had an initial base capital of Fts 4.6 billion, only 30 percent of it is cash. (The assets of the organisation amounted to Fts 6.8 billion).

The reorganisation activity of the HIDC—injected since that time until mid-May 1993 with a further Fts 4 billion (and a further Fts 4 billion is envisaged)—will be basically different from that of other organisations exercising state property rights (at least according to declarations). Since, in the case of the HIDC, we have to deal not with direct subsidies from the budget but with government investment, selections will be based on strict profit considerations and banking motives. The buying out of firms or the taking over of their debts will occur only if market based survival of a particular firm is a realistic goal (*Eller* 1993).

The HIDC, which obtained a banking licence in February 1993, and has been called since that time the Hungarian Investment and Development Bank (HIDB), performs three kinds of activity. On one hand, as proprietor it manages the 60 firms in its portfolio. Changing the proprietor of those requiring reorganisation might be the only way for survival. (For example, one firm obtained money from its new proprietor in order to adapt its quality insurance system to international standards. With another highly indebted firm the HIDB followed a strategy of high price sale after debt rescheduling.)

Another area of the activity of the state investment bank involves new investments. This does not concern reorganisation since its aim is to acquire shares in prospectively high-yield new ventures.

In the third area of the bank's activity (i.e. in reorganisation) there appears to have been no utilisation of the new possibilities opened up by the banking licence. Nevertheless, the bank has a plan to credit rescheduling, cancelling, debt-to-equity swaps and new, long-term credits in the case of firms ready for reorganisation (Kurcz 1993a). This activity of the bank will be supplemented by pledging guarantees and giving subsidized credits.

The investment fund (bank) tries to find partners who can assist in the financing of investments, and readily accepts institutional investors from developed countries.

However, the feasibility of this latter intention is not exactly in accordance with the ownership structure of the bank. This means that—as with the SAMC—it will always have government tasks. It will have to solve tasks assigned to it by government decree—on a for-profit basis, as the CEO of the bank asserts. This is rather a task for a planning office than for a bank operating according to market logic and interests (*Gyenis* 1993).

The HIDB is therefore not a true investment bank operating on a market basis; it offers long-term credit for higher than usual interest, with a long grace

period, and with ten to twenty years maturity to firms which are indebted but have a good market outlook. What would attract private investors to a state property bank pursuing government objectives? Also, it is not clear why such a bank would make better decisions than government decision-makers in other areas of the economy. Without money owners ready to invest (e.g. foreign investors), the bank will not have enough capital to assume an important role in domestic reorganisation. This is a risky activity and only a bank that has enough capital to invest in several ventures at the same time can assume such a risk.

Since there will not be enough money owners ready to invest, the HIDB will save individual firms selected according to their importance to the state. It will be one among the many institutions able to do this and the "for-profit motive" in its activity will dwindle away.

Debtors to be consolidated

A significant task of the HIDB, assigned to it by the government, is to take part in so-called "credit consolidation". This is crisis management with state money and is primarily intended to put banks in order. The Hungarian press mistakenly calls it "reorganisation". The credit consolidation programme had contributed up to mid-May 1993 only very indirectly to the consolidation of indebted firms. Since the method involves the buying up by the state of liabilities owned to the banks by indebted firms, it would in principle make life easier for firms indebted to commercial banks. (At the same time crisis management by the MIT has helped firms indebted to the state.)

In the first—already realised—phase of credit consolidation, the objective was to clear banks' portfolios and thus to prepare them for privatization. Given the fact that without a settlement for the debtors the need for consolidation would reappear soon, according to this logic firms which had "produced" debts should also be included in the next phase of the consolidation programme. The need for the programme shows that the buying up of liabilities cannot be left to the market; "frozen" debts have attained such a level that bad debts cannot be written-off simply by relying on the state.

Commercial banks participating in credit consolidation could rid themselves of more than Fts 100 billion worth of bad debt, even if the conditions of the programme were changed several times. These would be debts that they had been unable to collect for several years, or cases in which the debtor had been liquidated in the meantime. In practice, getting rid of bad debts has meant a debt-to-government bond-swap which has exempted banks from the otherwise unavoidable creation of reserves. Debts under the swap system have involved almost four thousand firms, and this system has been implemented, according to original plans, with a so-called

"Credit Consolidation Fund" held by the State Investment Institution. (This would have meant the sale, swap to equity, rescheduling or the cancelling of debt without the need for assent by the government or Parliament, as was originally required by the crisis management programme of the MIT.) (Szántó 1993)

The use of the conditional case is justified, since up to mid-May 1993 the law on the fund was not enacted. Thus debts that were already written down have been given back—under a commission contract—to the original holding bank. The proprietor of the assets is now the Ministry of Finance (MF). In the transitory period banks have to coordinate their steps with the MF. The many actors in the decision-making process tend to slow down bankruptcy agreements and liquidations, and the consequence of this is the devaluation of state assets at the firms concerned. (The position of debtors has deteriorated, rather than having improved.)

The role of the HIDB is to bring about the actual reorganisation of the largest debtors in the credit consolidation programme (Kurcz 1993a). The investment bank first investigated one hundred firms, whose debt constituted almost 80 percent of the total. During the three months at its disposal the bank tried to find out which of these firms should be saved and what measures would be needed for this. In this process, state criteria reappeared again. The managing director of the bank mentioned among the criteria of selection the "transitory effect" the non-payment of the indebted firm would have on its suppliers (*Csabai* 1993).

As a result of this investigation the HIDB decided to buy up Fts 40 billion worth of debt from almost 60 firms. The remaining Fts 60 billion worth of debt was given back to commercial banks. (From this time commercial bank decisions in corporate debt matters had to be negotiated by the HIDB, who represented the MF). The Fts 40 billion debt was bought by HIDB at market value, i.e. 10–20 percent of face value. Part of this revenue was in the form of a lump-sum, part of it was planned to flow in gradually, to be shared by the HIDB, the seller, and the MF according to a fixed ratio. The Fts 4–8 billion would therefore burden the HIDB not at the moment of buying but at the time of the inflow of the debt (Csabai 1993).

It is doubtful whether the investment bank will be able to manage such a high debt even if it is acquired for a minimal outlay, and thus it will still need the capital necessary for the recovery of debtors. Many of the latter will have been liquidated long ago, and even with "living" firms the bank will be only one among many creditors. The buying of debts is a "lucrative deal" for the investment bank in the long run since, as a result of an administrative act, it acquires billions due to a "trickle down" of income from all the cases of liquidation.

On the whole, the effect of the credit consolidation programme as a tool of central crisis management is dubious. Debt to equity swap has improved the balance sheet of the banks but the cancelling of the consolidation fee to be paid for the equity obtained has turned the construct into a bonanza (*Soós* 1993). This is despite the fact that it was originally meant for easing tensions, and for phasing out the losses

of banks by gradually drawing away the yield of government bonds. (Although in its original form the credit consolidation programme would have increased income, in the final version the government renounced the acquisition of future incomes.)

Another interesting feature of the programme is that the "big fish"—the foci of cross-liabilities among the 13 firms selected by the government—did not appear among the debts offered for swap. This development, which was a surprise for central economic management, relied on the rational considerations of commercial banks. For them it was easier to roll over or reschedule the really large and insecure credits than to declare them bad or dubious and to form reserves accordingly (Kurcz 1993a). In any case, the banks hoped that the cental management would settle the debts of these firms with a special formula (Csabai 1993). This expectation was not without foundation, since in the meantime the government decided to buy all the debts of the selected 13 firms (except one) from the commercial banks (Merényi 1993).

One cannot see as yet how much and what kind of capital will be needed for propping up firms—i.e. for the consolidation of debtors. There are preliminary offers from the World Bank and from the EBRD but the possibilities are not clear (*Barna* 1993).

It is no wonder that central management began the credit consolidation programme with bank consolidation, for this could be implemented by an administrative act and its capital needs could be determined centrally. However, with this the position of debtors did not change much.

Firms to be liquidated

The bankruptcy of firms not wanted by proprietors or which could not be saved meant that they could not avoid liquidation.[8] In cases of "forced" privatisation, (i.e. liquidation) there are some special characteristics contrasting with "voluntary" privatisation based on decisions by the proprietors.

In the case of liquidation the process is started with a considerable time lag after the bankruptcy request; this is because the judiciary is unable to process the large volume of requests. The time lag between the request and the implementation of liquidation makes it possible for participants to indulge in certain unlawful steps.

From the point of view of the firm to be liquidated, the main question is whether it will be able to secure continuous operation in the future. With many

[8] According to Western statistics, only 10 percent of the bankrupt firms are capable of being saved. These are firms who have a viable programme for "muddling through", who have assets to sell and who have good relationships with their creditors. In their case the moratorium on payments is only a supplementary measure, because they have tried to organize their survival at an earlier point (*Salerno and Hansen* 1991).

firms this is possible only by running through the assets of the firm. However, if this does not follow a well-conceived conception it can harm later outcomes as well as the chances of a recovery under a new proprietor. In Hungarian practice the main objective of liquidators nominated by the court is to keep the firm going and preserve its markets. Beyond the selling of a part of assets this objective is served by taking new credits guaranteed by the liquidator.

Life under the liquidation process is not the same, even for firms remaining in operation. An interesting feature of the reports on firms under liquidation is that important decisions that have been long delayed (but have all along constituted a precondition of financial reorganisation) are eventually made.

For example, in a firm producing parts for vehicles, its smaller subsidiary plants producing less important products, as well as social establishments and surplus inventories were sold and the product range was enlarged. In another firm considerable cost reduction was attained by transferring the central plant to another site. Yet another firm acted by firing a part of its workforce, discontinuing superficial activites, and introducing cash-flow analysis—all of which contributed to the establishment of "normal" operation.

In several cases special constructions for operation secured trouble-free functioning during the long liquidation process. Sometimes a joint stock company was formed for operation by employees. There is an example of an asset managing joint stock company that was created by creditors taking over the firm from the SPA. There was a case when the liquidation firm obtained the right to operate the firm in the transitory period.

Newspaper articles on the life of firms under the process of liquidation clearly demonstrate the drawbacks arising from the limited range of decisions for those concerned—i.e. the situation in which former managers cannot make proprietory decisions. Firms have complained that they have been unable to start new investments, to spend on the acquisition of new markets, and to take credits offered to them. Also, particularly injurious for them, was the fact that their advanced negotiations on forming a joint venture were slowed down. The reinstalment of government control also slowed down the process of liquidation.

For firms continuing their operation during the liquidation process it is of prime importance to attempt to put a stop to their loss-making. Firms which—when exempted from old debts—are deemed suitable for profitable operation and for market competition are more likely to find a partner if they are "going" or viable firms, and if they do not have to auction off their assets and abolish jobs. Firms that are likely to continue to make losses in the long run will be shut by the liquidator sooner or later.

Experience seems to show that for a liquidation to be successful much depends—beyond the firm's characteristics—on the skill, contacts, and attitudes of the liquidator. Efficiency in defending the interests of a creditor is different with "crisis manager"-type and"auctioneer"-type liquidators.

In reality it is generally the successor of the former state reorganisation organ who is accorded the task of liquidating firms important for the national economy, and through this successor central objectives are asserted during the liquidation process. However, with other liquidators there is also sometimes pressure for the individual treatment of particular firms. Government organs "suggest" that special solutions should be applied, or that particular persons should fill leading posts (*Molnár* 1992; *Zsubori* 1992).

Rapid, "cavalier-like" sales are generally produced by the same private liquidators. They approach their task in an innovative way. Rapid sales are advantageous for the firm since there is less time for the obsolescence of technology to become apparent, for the loss of markets, for being abandoned by the best part of the workforce, and for the decay of the firm. Rapid sales—perhaps in several instalments—largely depend on the flexibility of creditors—i.e. whether they accept a lower but surer refund rate. The selling of assets is not favourable for them, considering the large scale of the supply. Therefore they are ready to accept compromises.

All in all, the period of liquidation offers only limited chances for putting firms in order. In fact, it has the effect of preventing further decay. The slow change of a proprietor is deleterious for revival of an endangered venture.

Firms sold through liquidation

In Hungary there are still no firms that specialize in the purchase of liquidated firms. The number of ventures that buy up firms cheaply, improve them and resell them at higher prices is small. The explanation for this fact lies in the underdeveloped institutional system of money and capital markets and in the lower yield of industrial investment compared to the yield of capital invested in the financial sector. However, there are already signs on both the supply and the demand side that the situation is changing. As a result of the large number of liquidations, the price of bankrupt firms is falling to a more realistic level; however, this means that sharks specializing in the amelioration appear on the market.

Beyond the activity of the HIDB there are already a few consulting firms who plan to ameliorate and finance industrial firms. One of them (established with Fts 200 million base capital) has involved itself with an open-end joint stock company dealing exclusively with capital investment, as well as an investment fund. Both invest the money of shareholders in profitable Hungarian ventures. It has an active investment policy (i.e. it will control, on a continuous basis, the results of the ventures that have been financed). The future shareholders will be large investors, who accept a long investment period of eight years and 45 percent return. The

first venture capital investment funds have the role of filling the void which always existed in Hungary in the area of long term and risky investment (*O.Sz.A.* 1993).

The new type of credit allowance recently heralded by the government should also contribute to a livelier demand for firms due to be liquidated.[9] With such a decision the central economic management has expanded to state-owned firms under liquidation (or bankruptcy procedure) the interest subsidy; in the past this was given under the so-called "E-credit"—i.e. only to domestic buyers of state assets. Thus since the autumn of 1993 interest subsidy has been given to those domestic (i.e. Hungarian) persons and their partnerships who want to buy with credit the assets of at least 25 percent of state-owned firms or cooperatives. In this context, the own contribution should be at least 15 percent, and the interest subsidy should be at least 70 percent of the base central bank interest. Its period of refund is a maximum 15 years and the grace period is a maximum of 3 years (*V.F.I.* 1993).

This new measure is meant for to ease the purchase of property by domestic buyers and will undoubtedly contribute to employee and management buy-outs (MBO) of firms under liquidation.

MBO-s are also an important vehicle for putting bankrupt firms in order in developed market economies (Karsai J. 1993). In Hungary, however, there has been no MBO in the case of bankrupt or liquidated firms since new ventures have not been able to produce the income necessary for paying back principal and interest on credit, and there have been no capital investors who would assume the risk.[10]

Buy-outs financed by credit (without reliance on capital partners) are risky even in the case of subsidized credits. These draw capital away from firms that have recently been saved precisely at a time when they need new investment capital. New proprietors have no resources for this. (The Western models of MBO-s involve venture capital partners who assume a role not for the interest, but for the higher prices to be earned on shares when sold).

Among the buyers of liquidated firms research has increasingly shown that in the last one or two years large creditors occurred, i.e. commercial banks who know the firm as well as their own managers. This policy, adopted by certain banks, seems to be part of a conscious plan. These firms do not renounce their claims and do not swap them for shares, but wait for the liquidation process to be initiated in

[9] Interest subsidy given to reorganisation was, up to mid-May 1993, only obtained by those bankrupt and transformed cooperatives who operated efficiently with the resources at their disposal and who performed agricultural or attached activities (Kurcz 1993c).

[10] There was also one MBO firm on the list of firms to be liquidated. It was, however, a mistake to include it in the 1990 government list, since it did not show all the criteria necessary for liquidation. Its managers, after a successful self-reorganisation programme appeared with a purchase offer in the self-privatisation programme of the SPA. They were joined by two domestic investors. Since the employees also wanted to buy the firm the SPA gave the firm to a consortium of managers and employees. The buyers obtained subsidized credit.

ventures financed by them. This is so that they can buy up a firm at a low price, unencumbered, without having to be responsible for the unnecessary parts. The bank obtains its seemingly irrecoverable debt for a small sacrifice, without having to share the burden with the other creditors of the firm.

This "wait and see" solution which has been followed by commercial banks in case of glass, wood, and textile firms makes the continuation of bankrupt firms possible. It is questionable, however, whether the bank or the partnership created to manage the sale will be a better proprietor than the state. In the case of commercial banks in majority state ownership, it is a particular problem whether the motive of asset preservation will appear and give a new strategic direction to the recently acquired venture.

From among the "wait and see" purchases, until mid-May 1993 we can measure the impact of a change of proprietor with respect to a venture in one case only. In this case the firm had been financially reorganised and stabilized. This was secured first of all by reducing costs and by building up market and subcontractor relations. (*Szalai* 1993). In the case of the firm in question the result was not due to the care of the bank that bought it out. As an unprecedented solution in Hungarian practice, an entrepreneur assumed management with two of his colleagues as partners of a bank. This was done under a contract which assures them of the acquisition of further property shares parallel with the performance improvement of the firm (*Réti* 1991; Karsai G. 1993c).

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In the above it is hoped that it has been successfully demonstrated that Hungarian reorganisations are, from a market economy perspective, defensive rather than offensive. Reorganisation has been separated from privatisation, and has been a substitution for it. In other words, it has been accomplished by a state or state property organisation that leads to the increase of the budget outlay without passing firms over into the hands of true capitalists who have the money and act as capitalists. Reorganisation as a possibility contributes to the softening of the budget constraint of participants. For example, many firms hope that with elections approaching there will be a practice in which the preservation of firms is selective. This opinion seems to be collaborated by different "lists" of firms to be saved, as circulated by different government organs (*Peredi* 1993).

However, steps which are intended to neutralise selection among the actors of the economy, and are contrary to the logic of a market economy lead to the increase of inflation and indebtedness—i.e. they endanger the healthy development of the economy.

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STATE DESERTION AND CREDIT MARKET FAILURE IN THE HUNGARIAN TRANSITION

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State desertion is a rapid and continual decrease in the involvement of the state in the aggregate economy. An abrupt withdrawal of the state from the economic infrastructure that supports the allocational mechanisms is a contributing factor to the deep recessions observed in all CEE countries. Credit market failure is caused by state desertion of the financial sector leaving commercial banks burdened with bad loans. The paper describes the causes of and evaluates the proposed solutions for bad loan problems.

1. Introduction: The role of the state in the transition

For the first two to three years of the transition, all of the Central East European (CEE) countries in transition experienced deep recessions. The austerity programs pursued to stabilize these economies reduced private sector demand significantly. Liberalization of both prices and external trade added an inflationary shock to which the policy response was increased austerity. As the recession deepened, the tax base was eroded and transfer payments increased plunging the fiscal budget into serious deficit. The budget deficit soaked up private savings that would have been better channelled into financing the business expansion necessary to initiate and nurture the supply response to price liberalization. Given this vicious cycle, determining the proper role for the state to play during the transition in the CEE countries is crucial.

Due to its predominant, almost all-embracing, past role in the socialist bureaucratically managed economy, the state obviously must reduce substantially its economic activity in order to facilitate a successful transition to a mixed market economy. At the same time, the state must orchestrate the evolution and development of the environmental infrastructure necessary to support the growth of the market economy. According to *Chang and Rowthorn* (1994), the state must be involved whenever a new economic coordination structure is established. As it withdraws from micro-managing the economic sphere in the CEE countries, the state must accept responsibility for nurturing, but not smothering, the maturing market economy.

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That the state should be involved in developing the appropriate legislative support for the market economy is self-evident. It is equally important for the state to be an institution builder, i.e, an economic enabler as well as a legal enabler. In the CEE countries, system-specific legacies work against state intervention. The perception is strong that a continuing planner's mentality will perpetuate the petty tutelage of the earlier period. Such an attitude is a natural response to the over-centralization of the planning period. However, preventing state intervention may lead to state desertion and impede the transition to the market economy.

To conceptualize state desertion, we define two types. Type 1 state desertion is a rapid and continual decrease in the state's involvement in the aggregate economy. Such state withdrawal from macroeconomic activity could well be a contributing factor to the deep recessions observed in all CEE countries. Type 2 state desertion is an abrupt and discontinuous withdrawal of the state from the economic infrastructure that supports the allocational mechanisms. Since the institutional and behavioral preconditions for a well-functioning market are underdeveloped in CEE countries, state intervention (not state desertion) is required to fill the void. The state must create and nurture the economic institutions necessary to support the fledgling market economy. In this context, the major policy issue facing CEE governments is a lack of any historical precedence for such a radical restructuring of the state's role in so short a period of time. Hence the appropriate mix of state withdrawal and state support is difficult to ascertain.

The transition to a market economy requires the state to withdraw from directing the allocation of resources and leave this task to markets. At the same time, financial support is necessary if state-owned enterprises are to be restructured so that they can perform efficiently in the new market setting. Financing is also required to allow new ventures to become strong enough to introduce much needed competition to nascent domestic markets. While relinquishing its role in the direct allocation of capital, the state must support the creation of a market-based alternative, i.e., a healthy independent banking sector. Commercial banks should take over the intermediation of savings and investment. However, CEE governments did not grant the newly created commercial banks sufficient autonomy nor did they provide them with a strong enough capital base to carry out intermediation efficiently. Rather, the CEE states left a financial black hole in which a credit market crunch threatens the macroeconomic stability attained at an already high cost.

Our paper uses Hungary's experiences to illustrate the problems and issues to be dealt with sooner or later in all transforming countries. In the next section, we identify type 1 state desertion in Hungary even though the macroeconomic data turn out to be potentially misleading. In *Section 3*, we characterize type 2 state desertion of the Hungarian financial sector and conclude that the state acted irresponsibly in creating semi-independent commercial banks burdened with distorted loan portfolios of dubious quality. In *Section 4*, we analyze the severely dysfunctional financial distress resulting from credit market failure in Hungary.

In *Section 5*, we evaluate several proposals for resolving the bad loans problem in CEE countries. *Section 6* is a concluding one in which we recommend strong and decisive state intervention to strengthen commercial banks so that they may play their crucial intermediary role in the emerging financial markets in the CEE countries.

2. State desertion in Hungary: myth or reality?

Table 1

Summary of general government operations: international comparison (as percentage of GDP)

Country	Revenues	Expenditures	Deficit (−) or Surplus (+)
Hungary (1987)	**61.0**	**63.0**	**−2.0**
Hungary (1989)	**58.7**	**61.4**	**−2.7**
Hungary (1991)	**57.7**	**59.7**	**−2.0**
Hungary (1992)[1]	**56.5**	**63.6**	**−7.1**
Hungary (1993)[2]	**55.9**	**62.6**	**−6.7**
The Netherlands (1989)	51.1	56.6	−5.5
Sweden (1988)	59.1	56.9	2.2
Denmark (1989)	59.6	59.4	0.2
Belgium (1987)	47.8	54.7	−6.9
Austria (1989)	46.9	49.7	−2.8
France (1989)	46.2	47.8	−1.6
Germany (1987)	46.0	47.9	−1.9
Poland (1987)	47.4	47.6	−0.3
Romania (1987)	52.8	45.5	7.3
Canada (1987)	40.3	44.7	−4.4
U.K. (1987)	42.7	44.0	−1.3
Finland (1987)	42.7	43.9	−1.2
Spain (1987)	35.0	38.6	−3.6
U.S.A. (1987)	34.9	36.9	−2.0

[1]Expected for 1992 as of February 1993.
[2]Planned for 1993.
Source: Kornai (1992, p. 5) and *Murakőzi* (1992, pp. 1051 and 1053) for the data for countries other than Hungary. For Hungary data are revised and corrected by László *Borbély* of the Ministry of Finance.

János *Kornai* (1992) measures the predominance of the state in economic activity in Hungary by the ratio of general government budget operations to GDP. As *Table 1* indicates, the Hungarian government is directly involved in about 60 percent of Gross Domestic Product (GDP). The typical proportion in mar-

ket economies is between 40 and 50 percent (in the U.S. economy it is significantly below 40 percent). In *Table 2* consolidated general government expenditures and revenues as a percent of GDP are recorded for Hungary from 1985 to 1993 (target). Both ratios are inordinately high by international comparison. Moreover, expenditures as a percent of GDP have been increasing since 1990 in Hungary. In 1992, this ratio was higher than it had been in all but one of the pre-transition years. Does the data indicate that type 1 state desertion is a myth in Hungary? A satisfactory answer requires consideration of the economic situation at the beginning of the transition.

Table 2

Summary table of consolidated general government Hungary, 1985–1993 In percentage of GDP

Year	Total expend-itures	Total reve-nues	Enter-prise subsi-dies[1]	Consumer price subsidy	Health and education	Unemploy-ment com-pensation	Total expend-itures for households[2]
1985	60.9	60.3	13.2	4.8	10.2	–	28.3
1986	64.6	61.5	14.0	5.5	9.9	–	29.6
1987	63.0	61.0	13.5	5.4	9.5	–	28.5
1988	61.6	61.5	11.3	3.1	8.6	–	31.1
1989	61.4	58.7	7.7	2.6	10.1	–	34.9
1990 (adj)	(54.4)	(55.6)	(5.9)	(1.7)	(11.3)	(0.1)	(34.6)
1991	59.7	57.7	4.8	1.8	13.2	0.8	40.6
1991 (adj)	(50.8)	(48.1)	(4.0)	(1.6)	(11.2)	(0.7)	(34.5)
1992[3]	63.6	56.5	4.4	0.7	12.8	3.1	39.9
1992 (adj)	(51.4)	(45.6)	(3.6)	(0.6)	(10.3)	(2.5)	(32.2)
1993[4]	62.6	55.9	3.9	0.7	11.6	4.9	39.2

[1] Includes subsidies received from Central Government, Extra-budgetary Funds and Municipalities.
[2] In addition to the categories mentioned in the table includes expenditures on culture, sports, pensions, dependent care benefits and sick benefits.
[3] Expected for 1992 as of February 1993.
[4] Target for 1993 in the budget plan.
Source: Ministry of Finance; Hungary. Consolidated data are revised and corrected by László Borbély.
Note: For the years 1990–1992 we adjusted the data for the effect of the recession. Data in parantheses are ratios calculated by assuming no change in GDP from 1989 to 1992.

After having stagnated with low real growth in the second half of the eighties, the Hungarian economy slid into a recession in 1990 with real GDP falling by 3.5 percent. The recession deepened in 1991 and continued in 1992 as real GDP declined by 12 percent and 5 percent respectively so that the cumulative drop over the three-year period exceeded 20 percent. Might this recession explain why the

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ratio of government expenditures to GDP in Hungary rose while the state was withdrawing from macroeconomic activity? To adjust the data for the effect of the Hungarian recession, we calculate the expenditure and revenue ratios for 1990, 1991 and 1992 as if GDP had remained constant at its 1989 level.[1] Then, a starkly different picture emerges. As *Table 2* records, expenditures as a percent of 1989 GDP are 54.4, 50.8 and 51.4 for 1990, 1991 and 1992 respectively. For the same years, the ratio of revenues to 1989 GDP becomes 55.6, 48.1 and 45.6. Therefore, after adjusting for the recession, the aggregate figures do indicate type 1 state desertion. The adjusted ratio of expenditures to non-recessionary GDP fell by ten points (or almost 18 percent) from 1989 to 1992. Currently at about 51 percent, this ratio places Hungary in the upper tier of Western market economies.

Even if GDP is not adjusted for the recession, the state's withdrawal from micro-managing the aggregate economy is evident. From *Table 2*, subsidies to enterprises declined from 13.5 percent of GDP in 1987 to 4.4 percent of GDP in 1992. Consumer price subsidies as a percent of GDP fell from 2.57 in 1989 to 0.73 in 1992. *Table 2* also provides information on the changing composition of support for households. Support for health and education remain almost constant if GDP is adjusted. Unemployment compensation, which was nonexistent in 1989, grew to 2.5 percent of adjusted GDP in 1992 (and was forecast to reach almost 5 percent of actual GDP in 1993). Nonetheless, total support to households adjusted for the recession decreased from 34.87 in 1989 to 32.21 in 1992 for a decline of 2.66 percentage points. Consequently, aggregate state support of households was smaller by the end of the period due mainly to the decrease in direct subsidies. The composition of state support changed to reflect the new and growing social safety net.

Reducing the state's interference with markets by decreasing direct subsidies to consumers and firms is a necessary condition for the emergence of markets. However, reductions in overall government expenditures decrease aggregate demand and exacerbate the decline in GDP. When adjusted for the effect of the recession, the ratio of aggregate government expenditure to GDP fell by ten points over a three-year period in Hungary. Thus, type 1 state desertion is discernible in the Hungarian macroeconomic data and it has the potential to hinder and postpone the economic recovery. In what follows, we argue that irresponsible state withdrawal from the financial sector is definitely impeding the progress of the transition in all CEE countries.

[1] In market economies, recessions are accompanied by fiscal budget deterioration due to increased transfer payments and decreased taxable income. Although similar effects must be occurring in Hungary, we do not adjust the data to try to separate out cyclical from structural aspects of the fiscal budget.

3. State desertion of the financial sector

The severe decline in real output experienced in the CEE countries since 1990 has its roots in a credit market failure caused by state desertion of the financial sector. During the planning period, household and business money circuits were institutionally separate. The fiscal budget provided the necessary intermediation by transferring liquidity from the household or external sector to the production sector. Institutionally, the Central Bank extended the credit for business expansion designated by the plan and administered company accounts. Interenterprise transactions were recorded as debits or credits at the Central Bank; no separate payments clearing system outside of the monobank system existed. Credit policy was subordinated to planning as enterprise officials negotiated with bureaucrats to obtain funds for investment. Monetary policy as practised in a market economy using indirect instruments did not exist.

Hungary moved in the direction of market reform earlier than other CEE countries by dismantling the institutions of annual physical planning in 1968. However, the dominant role of the state in financial intermediation persisted. *Ábel and Székely* (1992) show that government money was the only causal explanation for liquidity in the business sector from 1974 to 1986. Monetized fiscal deficits provided overall liquidity to the economy prior to the restructuring of the banking system in 1987. Subservient to the state bureaucracy, the Hungarian National Bank played no major role in intermediating savings and investment. Until the banking reform in 1987, changes in the fiscal budget position and changes in interenterprise credit were inversely related (*Ábel and Bonin* 1992a). The business sector responded to any decrease in fiscal liquidity by increasing the length of the credit queue. Hence, the fiscal budget position drove credit market behaviour up to the time when the banking system was demonopolized.

As a precursor to (or as an essential first step in) the transition, all CEE countries created two-tier decentralized commercial banking systems from their central (monopoly) banks by breaking off entire credit divisions. In Hungary, the separation occurred in 1987 along sectoral lines.[2] The four newly created commercial banks, in descending order of assets, are Hungarian Credit Bank, Commercial and Credit Bank, Budapest Bank, and Hungarian Foreign Trade Bank. The largest Hungarian bank in terms of assets is the National Savings Bank which is the Primary collector of household deposits.

In all CEE countries, commercial banks are primarily state-owned (directly and also indirectly through ownership participation by state-owned client compan-

[2] In Czechoslovakia (separation in 1990) and Poland (separation in 1989), regional divisions were maintained.

ies).[3] Their initial portfolios were saddled with nonperforming (bad) debt. As newly created commercial banks, they held virtually no loan-loss reserves. The CEE states accepted no responsibility for the distorted portfolios inherited from discredited political regimes. For example, the three largest Hungarian commercial banks were insolvent according to international accounting standards from their conception. Consequently, CEE banks were bequeathed weak loan portfolios without any compensation government support. As such, they are all victims of type 2 state desertion.

The loan portfolios of these banks continued to deteriorate with the recessions. Such financial distress is not without precedence; financial systems all over the world have experienced problems in the last fifteen years (World Development Report 1989). However, CEE banks have particular characteristics that demand special attention when designing financial policy. The abrupt withdrawal of the state from the process of credit allocation left the newly created commercial banks as the primary conduits of credit in the economy. In particular, banks were expected to provide new capital to promising projects and ventures. However, by leaving them financially weak, the state abdicated its responsibility for the obligations that were incurred under the old regime. Type 2 state desertion makes it impossible for the banks to intermediate savings and investment efficiently.

In Hungary, the dilemma for the newly created banks was exacerbated by the New Banking Act, which became effective on December 1, 1991. This act introduced specific categories for rating the loan portfolios of the banks, mandated the accumulation of provisions (loan-loss reserves) against the qualified loans in the portfolio, and specified a schedule for meeting international capital adequacy targets. Although this legislation was designed to make Hungarian banking standards more consistent with international ones, the provisions required against bad loans severely impacted the banks' ability to make new loans. The cost of services and interest spreads were maintained at levels high enough to allow banks to generate sufficient cash flow to accumulate the required loan-loss provisions. In essence, the New Banking Act imposed a flow solution on the (bad debt) stock problem.

The bad loans left on the books when the commercial banks were created became a burden on the healthy segment of the commercial sector. Companies that serviced their loan obligations did so at unusually high interest rates. High financing costs discouraged small entrepreneurial activity, inhibited entry of new firms, and precluded the capital injections necessary to restructure potential profitable state-owned enterprises to prepare them properly for privatization. By pricing investors

[3] The direct ownership share of the state in the four large commercial banks varies between 35 percent to 50 percent but the residual in all cases consists almost entirely of ownership shares held by state-owned companies. This arrangement creates the curious situation that company privatization increases the state's ownership share in the commercial banks because the company's share reverts to the state when it is privatized.

out of the market, the commercial banks promoted further stagnation. By refusing to accept responsibility for the legacies of the past, the state left the banks with no alternative. Type 2 state desertion of the financial sector seriously impaired the ability of the newly created commercial banks to carry out their primary function, namely to allocate credit on economically rational grounds.

In leaving commercial banks burdened with bad (inherited) loans, the state substituted its earlier transparent support of ailing companies through direct fiscal subsidies with nontransparent financial redistribution. Companies with nonperforming loans had their interest arrears capitalized by the banks. Furthermore, the banks continued to do business with their old clients, many of whom held ownership shares in the banks, even when these clients' did not meet interest obligations. Consequently, the stock of bad debt increased. The healthy segment of the commercial sector supported ailing companies by paying high fees for financial services and high rates for loans. These financial transfers were less transparent than the earlier direct subsidies from the fiscal budget; moreover, as we develop in the next section, they were severely damaging to the health of the emerging market economy.

4. Credit market failure: the consequence of state desertion

Although the three largest Hungarian commercial banks were insolvent by international standards from inception, the banking system generated large cash flows from the beginning of the transition.[4] In 1991 and 1992, household deposits grew rapidly in Hungary. An interbank market transferred these deposits from the National Savings Bank to the commercial banks. Unsterilized injections of foreign exchange in accounts opened by foreign companies doing business in Hungary added further liquidity to the banking system. Although the supply of loanable funds increased substantially, interest rate spreads remained large. Even when inflation declined in 1992, nominal lending rates remained high.[5] The commercial banks used this increased liquidity to attend to solvency problems by accumulating the provisions required by the new banking legislation rather than to take an active role in providing credit to the emerging private sector.

[4] In 1990, profit margins were high enough for taxes and dividends from the financial sector to constitute 7.6 percent of fiscal receipts (Ábel and Bonin 1992b).

[5] The spread in real interest rates was even greater due to the difference (about 9 percent in 1992) between CPI and PPI inflation. Historically, margins in the retail sector had average about 10 percent. As retail trade became increasingly privatized, margins increased to approach those in Western market sectors which average 30 percent to 40 percent. The difference between the ratio of tradeables to nontradeables also explains gaps in CPI and PPI inflation. Since real household deposit rates should be calculated using CPI while real commercial lending rates should use PPI, the spread of real rates was even larger than the spread of nominal rates.

The high spreads maintained throughout this period made borrowing from domestic banks unattractive to high-quality commercial costumers and led to credit market failure in Hungary.[6] On the demand side of the loanable funds market, the Hungarian production sector can be divided into three tiers consisting of good, struggling, and bad companies. The first tier consists of currently profitable companies that tend to operate either in export-oriented activities or in retail trade. These companies either generate sufficient internal funds to finance investment or, if they are joint ventures, they obtain credit from the mother company. Moreover, domestic companies exporting to Western markets have access to international capital markets at rates that cannot be matched by Hungarian banks. Hence, good companies tend to avoid the domestic credit market and the Hungarian banks are left with lending opportunities mainly in the second two tiers.

The third tier consists of companies that are already heavily indebted and, due to the nature of their markets, cannot continue to exist in their present form (e.g., many Hungarian SOEs in heavy industry and the energy sector). These companies will ultimately either be forced to enter bankruptcy proceedings or become chronically dependent on subsidies from the state budget. In the former case, liquidation or reorganization will occur. Obviously, these are not good credit risks for a bank attempting to improve the quality of its portfolio. Hence, unless they are forced to do so by the state for political reasons, banks are no longer extending new credit to this tier.

The middle tier consists of companies that are currently struggling, due primarily to the deterioration in the domestic economy, even though they are potentially profitable under normal conditions. To become profitable, a company in this tier may need to change both its market outlook and its management and to introduce new products and new technology. An injection of new capital, financed either by a strategic partner (equity) or by long term bank credit, will be required to transform such a company into a profitable venture. The only strategic partner with sufficient equity and know-how to accomplish the task in the near future is a foreign company. Until the nondiversifiable (macroeconomic and systemic) risk is reduced, foreign equity cannot be attracted in sufficient quantities. However, the commercial banks are equally reluctant to take the risk involved with restructuring companies that have yet to prove their creditworthiness. Hence, the stagnation and the "wait and see" attitude of creditors and potential equity holders.

Consequently, the Hungarian credit market exhibits an undesirable separating self-selection equilibrium in which the creditworthy borrowers are not interested in borrowing from the domestic banks and the riskier borrowers remain as the only available clients for these very banks. As a result, the increased supply of household savings observed in Hungary during the first three years of the transition is not directed toward the production sector because the commercial banks that were

[6] See *Thorne* (1992) for a discussion of financial de-intermediation in Eastern Europe.

created to perform this intermediation are concerned about the quality of their portfolios. Instead of providing credit to the business sector, Hungarian banks have chosen to purchase government securities and channel domestic savings to financing a fiscal budget deficit which was above 7 percent of GDP in 1992 (*Table 1*). Hence, business investment is crowded out by fiscal expenditures because the banks find the risk-return bundle on government securities more attractive.

The brunt of the Hungarian credit crunch is born by potentially profitable but risky ventures (both creating new companies and restructuring middle-tier companies). Yet even though they are financially risky, new businesses must be encouraged to lead the country out of its recession and provide jobs for the workers being laid off as SOEs restructure. Due to the provisioning requirements against bad loans, Hungarian banks are currently unable (and prudently unwilling) to intermediate savings and investment effectively. Hence, the production sector does not receive the new capital it requires and the end to the recession is brutally slow in coming. Neoclassical economic theory argues in favour of government intervention to redress market failure. The Hungarian state should take this lesson to heart and assume its responsibility for creating an undesirable outcome in the credit market when it dealt the banks a weak hand, i.e., the bad loans problem.

5. The bad loans legacy: an evaluation of proposed solutions

At the time that the commercial banks were created, the bad debt in CEE countries could have been recognized as inherited from the previous regime and removed from the balance sheets of the banks. The consolidated balance sheet of the state would be unaffected since the state (either directly or indirectly) owned both the banks and the companies. Any decrease in state assets (loans on the banks' balance sheets) would be matched by an equal decrease in state liabilities (the companies' debts). If it had sufficient information to evaluate the loan portfolios when the banks were created, the state could have designed a credible once-and-for-all bad debt cancellation program.[7] Then the newly created commercial banks would have started their life with cleansed balance sheets and had not been burdened with the bad-debt albatross.

Although this argument is compelling, it would not have resolved the problem of inherited weak portfolios. Even if all the bad debt in the original portfolios had been removed, the situation of the commercial banks would still be financially fragile today. The deep recession and the loss of the Soviet market added significantly to the stock of nonperforming company debt in CEE banks. Long term loans made and long term obligations taken with clients during the previous regime turned

[7] To avoid any incentive for banks to continue making bad loans because they expect subsequent bailouts, *Caprio and Levine* (1992) recommend linking debt forgiveness to bank privatization.

bad because of these macroeconomic shocks. Hence, the portion of current bad loans that was actually inherited from the previous regime is difficult to identify. Furthermore, a forward-looking classification of the loan portfolios is difficult to accomplish. In some cases, debtor companies are antiquated with obsolete capital and no competitive market position. Evaluating such assets is a relatively simple task as it amounts to estimating scrap values. For most companies, the uncertainty of future profit streams makes a realistic "market" value of the assets difficult to establish.[8] In the intermediate stage of the transition, portfolio evaluation is still a difficult task.

To avoid the issue of identifying bad debt, *Beggs and Portes* (1992) recommend removing all inherited loans from bank balance sheets. The state is then charged with the responsibility of "marking these loans to their market values" and, thus, making transparent the actual condition of its consolidated balance sheet. Although such a proposal forces the state to take responsibility for decisions made by previous regimes, the removal of the entire stock of inherited debt from bank balance sheets would have undesirable consequences. From the bank's perspective, the balance sheet must balance so someone has to pay for debt cancellation. One possibility would be to reduce bank liabilities sufficiently to offset exactly the reduction in bank assets. Then debt removal would be financed by writing down the deposits of healthy profit-making companies and private households. Given the magnitude of the stock of inherited debt, the confiscation of such a significant portion of deposits would surely destroy confidence in commercial banks.

Recognizing this fact, Beggs and Portes (1992) recommend issuing government bonds equal in face value to the loans removed.[9] They stress that the securities should earn a market rate of return and be sufficiently liquid to avoid having their value eroded by inflation. If all inherited debt is replaced in this fashion, the asset side of banks' balance sheets would consist mainly of liquid government securities. If the banks are sufficiently independent of state control, they can expand their loans and investments subject to a fractional reserve requirement on deposit liabilities. The additional liquid bank reserves created by this exchange is potentially inflationary. To reduce commercial banks' free reserves, the central bank could increase the reserve requirement (temporarily) to attenuate the inflationary impact of the government issue.

When amended to recognize its potential inflationary consequence, the Beggs-Portes proposal leaves the relationship between the central bank and the commercial banks in a rather primitive state. The central bank retains control over the

[8] To avoid having to evaluate entire bank portfolios to determine how much debt should be removed, *Scott and Levine* (1992) have suggested forgiving bad debts only when the enterprise is privatized.

[9] For Poland, Beggs and Portes estimate the financing implications of this policy to be between 2 percent and 3 percent of GDP. Whether or not such an addition to the fiscal deficit is feasible or warranted can be argued.

aggregate level of credit while commercial banks are encouraged to take independent allocational decisions. However, reserve requirements are likely to be quite high. The banks would be making loans for which they would be held fully responsible. Yet with high reserve requirements, the cost of funds is likely to be high. As a result, the cost of credit would be high. Consequently, an infusion of liquid government securities accompanied with high reserve requirements to offset its inflationary potential is not likely to jump-start lending to businesses and unblock credit markets.

The proposal also presumes that the state has the resources and capabilities to manage the entire portfolio of inherited debt as effectively as the banks. However, the individual commercial banks are the best sources of information about their clients. As such, they are able to monitor better managerial (e.g., asset stripping) and to work out the problem parts of their portfolios more successfully than a centralized government agency. *Bonin and Mitchell* (1992) develop a model in which the value of the state's assets will be higher if banks rather than a state agency work out the problem loans. Both moral hazard considerations and informational asymmetries make the centralized work out of bad loans suboptimal from the perspective of state wealth maximization.

More than likely, the government authorities in the CEE countries have understood that removing all inherited debt was infeasible.[10] Each state opted for some form of decentralized policy in which the banks were given the responsibility to work out their bad debt. At the same time, banks were required to accumulate reserves against the qualified part of the portfolio. However, this policy of bank self-reliance with its accompanying provisioning requirements is the primary cause of credit market failure in Hungary (as we argue above). The proper policy is for the state to avoid type 2 desertion of the financial sector and resolve the bad debt problem.

Since Hungarian commercial banks are required to evaluate their portfolios according to the requirements of the Banking Act, it would be possible for the state to remove only bad loans from bank balance sheets. Unless properly designed, this approach would penalize banks that have already accumulated significant provisions. To remove only the bad loans against which sufficient loan-loss reserves are held amounts to confiscating funds from healthier financial institutions. Thus, proper bank governance would be discouraged. An attractive alternative would be

[10] In 1991, Czechoslovakia adopted a program in which 20 percent of the existing commercial loans were transferred from the banks' balance sheets to the newly formed Consolidation Bank. Although this program was the most adventurous among CEE countries with respect to debt removal, it still left Komercni Banka, the largest commercial bank in the Czech Republic, with a shortfall in loan loss reserves of 9 billion koruna (or about 5 percent of its remaining loan portfolio) for 1991. The Hungarian government negotiated with the banks to guarantee about 10 billion forints of doubtful loans purported to represent about half of the existing bad debt at the time that the commercial banks were created in 1987.

recapitalization of the banks using subordinated debt, either government-issued or government-guaranteed (private) debt. Bank net worth would increase and loan work out would be left in the hands of the commercial banks. These banks are in the best position to handle this task because of the information they have on their clients. This combination of decentralized bank work out (self-reliance) and government-assisted recapitalization is preferable to centralized schemes based on debt forgiveness alone.

7. Conclusion: state withdrawal vs. state desertion

The transition to a market economy requires state withdrawal in the aggregate sense of decreasing the role played by the state in overall economic activity and in the petty tutelage sense of eliminating direct interference with market activities. However, the state must not abdicate responsibility for the burdens that past decisions impose on evolving institutions. Rather, the state must become an economic enabler; it must build and strengthen the environmental underpinnings on the emerging market economy. In Hungary from 1990 on, the aggregate data on subsidies clearly indicate a rapid decline in the state's direct interference with production and distribution. By adjusting government expenditure to GDP ratios for the recession, we demonstrate a rapid and continual decline in the state's involvement in aggregate economic activity (type 1 state desertion). The level of support to the household sector is also declining even as unemployment compensation transfers increase rapidly. State desertion of this type has the potential to lengthen and deepen the recession in Hungary.

The Hungarian state's abrupt and discontinuous withdrawal from the process of credit allocation (type 2 state desertion of the financial sector) is unambiguously deleterious to the health of the nascent market economy. Inherited bad loans inhibit the newly formed commercial banks from performing effectively their intermediation function. Credit markets exhibit a separating self-selection equilibrium in which good risk clients are driven away from domestic banks by the high cost of funds and services. As a result, the commercial banks assist in the crowding out of private investment as they attempt to improve the quality of their portfolios. Hence, companies attempting to restructure and newly emerging entrepreneurs face a severe credit crunch. The state must intervene to break the gridlock and jump-start investment in the productive sector.

Why should the state be held responsible for the quality of the banks' portfolios? By reducing subsidies to companies, the state withdrew its direct fiscal support leaving these companies in a precarious financial condition. These loss-making companies were heavily indebted to the commercial banks. Furthermore, the recession and a more stringent bankruptcy act in Hungary combined to make

more client's loans bad according to the classifications in the banking act. As a result, Hungarian commercial banks continue to support unhealthy companies with non-transparent subsidies (e.g., interest capitalization). The state not only deserted the financial sector; it continues to contribute to its distress.

How should the state walk the tightrope between helpful assistance and meddling interference? The objective is to provide the support necessary to nurture the development of credit markets. As a precondition, the state must assume responsibility for the bad loans problem. In doing so, it must not interfere directly with the lending activities of the commercial banks. Therefore, the Hungarian government should continue its self-reliance program but at the same time it must inject fresh capital into the banking system. By using subordinate debt to recapitalize the banks, the state would both accept responsibility for the legacies of the past and maintain the necessary arms-length relationship with the commercial banks.

State desertion (type 2) of the fledgling financial sector imposes too great a cost on the economy. The peculiar type of credit market failure that evolved in the CEE countries requires government intervention to assure the healthy development of market institutions. On the road to the mixed market economy, the state should withdraw from economic activity but not abdicate its responsibility to address market failures. State desertion has the potential to stall the transition indefinitely.

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MONETARY AND BANKING POLICY DURING THE PERIOD OF THE ANTALL GOVERNMENT

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After the assumption of power of the first government (the Antall Government), significant advances soon became evident—relative to and mostly as the result of the "inertia" of certain processes started earlier—in the modernization of the system of financial institutions. The government, however, did not utilize the power of the capital market, which would have been capable of organizing the economy and improving the efficiency of the real economy. Instead, the government used it for its own narrow-minded fiscal and power interests. Therefore, the circumstance in which the government has created a banking system which has a reduced operative capacity, is due not only to objective difficulties but also to a mistaken policy and negligence. In addition, the development of methods of monetary control have, so far, not produced good results: the central bank, since it gained independent legal status, has failed to exhibit efficient use of the arsenal of monetary tools. The initial ill-matched successes of the economy (albeit taken over in an unstable condition) were followed by unequivocal failures in which, in addition to some mistaken elements in the economic policy of the government, the weaknesses of monetary control also played some part.*

What did the Antall Government inherit?

The favourable side of the inheritance: modernization of the system of monetary instruments

When the system of monetary instruments was taken over by the Antall Government, it was already in an advanced state of modernization. The Hungarian banking system had been changed into a two-tier system in 1987 and it had became "multi-coloured" due to the increasing number of small banking institutions; thus, despite its weaknesses, it counted as the most up-to-date banking system of the Eastern Bloc. By 1990 the initial segmentation of the banking system had become looser: the commercial and the specialized banking institutions also gained the opportunity to pursue services for the population, and many of them extended their activities into foreign-exchange transactions as well. Even in the National Bank of Hungary (NBH), which got rid of its commercial functions, modernization of the monetary system of instruments had been started, though its efficient application was restricted by the subordinate position of the bank and the underdevelopment of the Hungarian money economy.

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It can also be considered a favourable inheritance of the Antall Government that the preparation of both the law on banking institutions (built upon the unifying regulations of the EC, as well as the law on the issue bank, which settled the position of the NBH) had reached an advanced state by the early days of 1990. The bill on the NBH was ready for being put before Parliament early in the spring of 1990; the president of the NBH had already gained the agreement of the new political parties (i.e. including the opposition) to the bill.

The banking system was developed not only in relation to that of the Eastern Bloc but also with consideration being given to other sectors of the Hungarian economy. In the late 1980s the ideas which intended that the banking system should have a central role in the modernization of the Hungarian economy and its world economic integration, seemed to be perfectly realistic. At that time the Hungarian banking system and capital market still seemed to be appropriate for establishing Hungary's role as a "bridge" between Eastern and Western Europe. This historical chance was missed due to the mistaken economic philosophy and strategy of the government (and in addition to the unfavourable development of the external environment). The government did not utilize the economy-organizing power of the institutional system of the capital market for increasing the efficiency of the real economy, but made it serve its narrow-minded fiscal and power interests.

The unfavourable side of the inheritance: open and latent tensions of internal and external equilibrium

From among the factors comprising the unfavourable inheritance, in the first place the open and latent tensions of the financial equilibrium have to be mentioned. The obvious upsetting of the equilibrium was reflected by growing inflation, deterioration of the balance of payments, and a slight increase in indebtedness in the wake of the liberalized economic policy of the Németh Government. Although the worsening of the balance was latent, it was also inherent, due to the consistent implementation of the liberalization programme (liberalization of prices, wages and imports, and the reduction of subsidies). On the other hand, another factor indicating latent deterioration of the equilibrium could be detected in the fact that the enterprises responded to the worsening relations in the foreign markets and to the narrowing domestic demand by the conventional mechanism of the planned economy: namely, by increased queuing. In other words, the accustomed growth rate of the economy was maintained.

The Németh government which preceded that of Antall, by starting the liberalization programme, to a certain extent "swallowed the bitter pill" and so created a somewhat more favourable initial situation for the new government. It also set the path for a liberal economic philosophy. However, the most important and painful

tasks of winding up the planned economic system were left to the new government. Some of these, primarily the law on bankruptcy and the up-to-date laws on accounting and on banking institutions, in fact strengthened the recession of the economy and exacerbated the financial disequilibrium. In the course of "assessing" state property for privatization, the property itself was devaluated; thus, simultaneously, there was an increase in the value of debts which were earlier raised by the state enterprises, and for which such property served as security.

The results and problems of institutional modernization

An important stage of modernizing the banking system was the adoption of the legal framework of European norms. First among these was the enactment of the laws on the National Bank and the banking institutions. Then came the laws on accounting and bankruptcy; together, these implied an adjustment to the market economy. In addition to the laws appropriate for a market economy, significant modernization had taken place in the arsenal of instruments applied by the system of monetary control of the NBH. Progress was made towards more flexible, market-oriented monetary regulation. However, the efficiency of the new tools was markedly reduced by the burdens imposed on the NBH by the inconsistent objectives of economic policy, by increasing state debts, and by the deficiencies of monetary planning.

Nevertheless, institutional modernization did not bring about the expected positive effects. One of the reasons for this was that it was implemented at an inappropriate time and with poor scheduling. This was because it occurred at a time when the participants of the economy were shocked by other changes in the real economy and also by the regulatory system. The collapse of the East European political regimes involved the caving in of their respective economies and the trading connections built upon them. This shook the market position of the relatively small Hungarian economy. The recession in the Western economies and protectionism emerging in the wake of it, made it difficult for the not particularly competitive Hungarian economy to change its markets (or, at least, it increased the costs of doing so). Hence, parallel with this, the hardening conditions of regulation and the rapid appearance of the market economy, especially afflicted those Hungarian companies suffering from certain other objective disadvantages.

Another reason for the failure of the modernization process was the hesitant economic policy (we might rightly call it a "wavering policy"). The government was frightened by the foreseeable—though, at that time underestimated—effects. In other words, most participants in the Hungarian economy and precisely those large organizations which were important for the state power (large enterprises, big banks), were unable to meet the newly established norms of the market economy. A

consistent implementation of modernization would have meant that the traditional actors of the economy would have had to disappear from the scene, thus yielding their positions to new participants (proprietors, managers) who would be able to comply with the norms. It is true that the economy could have survived the shocking effect brought about by the enormous disturbances (regression, unemployment) caused by the laws. However, the exacerbation of the situation was due to the aforementioned problem of scheduling.

Despite the problems of scheduling, the laws marked the way towards a market economy. This includes those laws passed in 1991–92: on the NBH, on the banking institutions, and on bankruptcy and accounting. These can be considered part of a process of significant progress.

The law on the issue bank

The law on the NBH, defining its necessary legal status for operation as an issue bank, brought about significant changes for the NBH, as compared to the earlier situation (in which there was no law at all). According to this law, the president of the NBH and his deputy are appointed by the President of the Republic and they are obliged to give accounts only to the Parliament. An autonomous tool of the issue bank for influencing the economy involves the policy of interest rates. However, according to the law, although the development of the exchange rate is within the common competency of the government and the NBH, in reality without the approval of the NBH the government can make no decision on exchange rates.

Whereas the NBH, based on its present legal status, is largely independent of the government, the pressure exerted on it by certain government bodies has not ceased. Although the law restricts the amount of issue-bank credit which is allowed to be extended to the budget, the burden of the responsibility of financing the budget deficit that exceeds this quota, by laying out state papers, lies on the NBH. The significant and rapidly growing stock of state papers imposes additional tasks on the NBH, and these may easily endanger the fulfilment of its basic mission—namely, to reduce inflation.

The problem of keeping up with the financing of the budget led to an amendment of the law on the NBH at the end of 1993. This created almost unlimited possibilities for the issue bank for financing the transitory shortages of liquidity of the budget. A progressive element of the amendment is that it allows for the gradual transformation of the (so far) interest-free state debts into state papers, subject to the market conditions. In the long run, this should mitigate the burdens the NBH imposes on the business banks sector. In the last analysis, these burdens are carried by those clients of the banks who are borrowing or depositing money.

The law on the banking institutions

The law on the banking institutions was built upon rules commonly accepted in Europe, and which have been growing ever more uniform. This law came into force in December 1991, and it symbolised an important step in the series of laws aiding the transition to a market economy. By making sure there was a commitment to maintaining capital adequacy, by forming reserve funds for risks, and by controlling the owners and big borrowers through the authority of the bank supervision, the legal conditions of safe banking operations *in principle* were thus provided. The law placed the authority of bank supervision, which earlier had worked within the framework of the Ministry of Finance, under the direct control of the government. In has proved to be a correct decision to make the supervision of banks independent of the Ministry of Finance. The latter is responsible for realizing the budget, especially given the serious equilibrium problems of the state finances. In other words, in the present situation, the supervisory authority can call others to account for the formation of reserve funds. The latter appear as a counterpart to the budget which is interested in the revenues of taxes and dividend incomes.

With this law the government has been able to influence the structure and development trends of the banking system. The path driven by the law, however, does not reflect the trends asserted in the European capital market. The legislators—in compliance with the spirit of the earlier enacted law on securities, which excluded banks from the stock exchange—supported a banking model which was less universal than the one defined by European trends. According to this law, in addition to trading in securities, the banking activities of investments also have to be separated from the banks which keep accounts.

In addition to the bank model to be followed, another dilemma was raised by the question of whether (or to what extent) it would be necessary to bring the proprietary sphere of the banks under control. Besides the limitations customary in international practices (e.g. registration of influential ownership by the supervisory authority), the Hungarian legislators deemed it necessary to delimit the proprietary role of the state as well. The Parliament wished (primarily with the support of the opposition) to create a guarantee that the practically hegemonic state ownership would be broken down. This was primarily in evidence in the cases of the biggest banks. By stipulating that from 1995 onwards the state would not exercise its right of voting (linked to its share of property, which exceeded 25 percent) and would be obliged to alienate that part of its property which would be beyond 25 percent, the latter being the limit. (The law allows a 25 percent share for any owner whatsoever, with the exception of banking institution, defining a maximum grace time of one year.) With regard to the ownership structure, heavy discussions were also elicited by the judgement on foreigner citizens. The protection of "national property" came to the fore especially strongly in the case of the big banks which

were directly able to influence a decisive part of the economy and serve as the chief medium for creating money. Finally, the law in force keeps the property share available to foreigners at the previous conceptual level (i.e. it should not exceed 10 percent) and specifies the conditions for obtaining the permit.

A significant and increasing number of banks were unable to meet the safety requirements of banking stipulated by the law on banking institutions. In order to reach the prescribed level of the capital adequacy index, the majority of Hungarian banks needed, and still need, the help of the state (see the consolidation of the credits and banks). However, not only bad debtors endanger the safety of deposits, but also wrong proprietary behaviour; this was reflected by the bankruptcies of small banks, which occurred in 1992.

The law on bankruptcy and accounting

In the modernization of the institutional system of banking, the laws on bankruptcy and accounting also played a significant part. The law on accounting deprived the enterprises and banks and—owing to the shortfall in the tax revenues—even the state of those fictive incomes which formerly covered up the losses. The passing of the law was an important step in setting up the norms of a market economy: it has put the category of income into its right place, and has made the economic units interested in collecting their outstanding debts and taking more resolute measures against the spreading delays of payments.

The timing of the introduction of the law aimed at paving the way for the norms of a market economy was, however, unfortunate. Under the conditions of the earlier regulation neither the banks nor the companies were able to make preparations for writing off the losses stemming from bad outstanding debts. This was because it was only the laws on the tax of associations and on the banks that created the possibility for forming reserve funds (to the debit of the cost accounts designated for such purposes). Owing to this, the income situation of those engaging in economic activities significantly worsened. Besides, the introduction of the law came to pass precisely at the time when the collapse of the companies' traditional (eastern) markets shook the foundations of the economy.

The effect of the shock was strengthened by the law on bankruptcy. This came into force on January 1 1992 and was aimed at increasing financial discipline and winding up queuing, which had became a chronic phenomenon. However, by introducing the obligatory declaration of one's own bankruptcy, the law laid down stricter conditions against the debtors who did not (or could not) pay, than those applied in the western world. The commitment specified in the law obliged the debtor, independent of the amount of the debt and the creditor's intentions, to declare bankruptcy if he or she had a debt which had been mature for more than

90 days. Hence the bankruptcy not only provided an opportunity for the debtor to make an agreement with the creditor but meant, at the same time, a constraint on the creditors. (Since the law allowed only the debtor to declare bankruptcy, the only way to be chosen by the creditors was to initiate a liquidation process.) Therefore the law led to a great number of bankruptcy and liquidation proceedings, and a timely concentration of these in the course of 1992.[1]

Since the law on bankruptcy came into force almost simultaneously with the laws which created real possibilities for filling up the reserve funds for the risks, the chances of making bankruptcy agreements became less than they would have been if the timing had been more favourable. The waves of bankruptcies and liquidations that were concentrated in time also endangered the frail stability of the banking sector, given the latter's lack of reserves sufficient for writing off the huge credit losses. Finally, in the summer of 1993, the "mitigation" of the law came to pass: the obligatory declaration of one's own bankruptcy was cancelled and the moratorium on payments linked to the bankruptcy became subject to the permission of the creditor.

Modernization of the tools for monetary regulation

Although endeavours at modernizing monetary regulation can be traced back through recent years, their real effect is only perceivable in the development of the instruments adapted to the market, rather than in the improved efficiency of monetary control. The operation of the formally renewed tools of regulation continued to be restricted by the contradictory system of economic-political objectives and by the low sensitivity of participants in the economy to monetary warnings. The expectations related to economic policy were illustrated mainly with the interest rate policy, and this caused hectic convulsions in the relations of the money market with regard to savings. The depressing effect of the deficit in state finances and debts can primarily be detected in the regulation of the reserve rate and in the open market transactions. However, it was also evident in the severity of prescriptions regarding the keeping of liquid assets, which increased in 1993; while all these served to narrow down the money-creating capacity of the banks and the liquidity of the economy, the chosen method, at the same time, provided direct financing of the state debts. The inflexible and delayed reactions to monetary signals hindered

[1] In 1992, 2600 organizations initiated bankruptcy proceedings; these affected altogether 8 percent of the gross production value of the economy, and 11 percent of the labour force employed. The number of organizations under liquidation proceedings was more than 3700 and affected 18 percent of the gross production value and 22 percent of those employed. At the end of 1992, almost 200 organizations were under bankruptcy proceedings and 1400 under liquidation procedures. *Source*: Ministry of Finance.

the effectiveness of the policy of "small steps"—i.e. of fine regulation in the policy of both interest and exchange rates.

Despite the initial weaknesses, it is a considerable advance that in the past three years a positive shift has appeared towards a regulation based on market mechanisms (i.e. towards interest and exchange rate regulation and open market transactions). Parallel with this, direct regulation of the money supply via short-term refinancing credit limits was gradually repressed, and by 1993 practically ceased to exist. It was replaced by refinancing methods which followed more precisely the relations of the money market, by the exchange of foreign-exchange deposits, and by repurchasing agreements ("repo" transactions). From 1993 on, the determination of the repo interests became the main instrument for regulating the liquidity of the banking system.

In 1991–92 the *open market transactions* of the issue bank were still only one-sided, albeit beside the plentiful liquidity which resulted from the decrease in the crediting activities of the banks—namely, it was almost exclusively active transactions (the selling of state papers) that were made. The system by which the repurchasing agreements increased the liquidity of the banks did not become widespread until 1993. By 1993–94 a peculiar situation emerged, because a break in the development of monetary regulation was involved in the fact that, due to crises facing several members of the banking sector (and, following this, in the credit- and bank-consolidations and the increased stock of state bonds in the bank portfolios), the banks participating in the consolidation once again came under the influence of the leading-string of the NBH. In other words, their liquidity came to depend almost entirely on the refinancing policy (i.e. the readiness to make repo-agreements) of the NBH.

Together with the increased role of open market transactions, the tools available for interest rate policy also changed from 1991 onwards. With the narrowing down of direct refinancing, the direct regulatory function of the basic issue-bank interest rate also decreased. The NBH annulled the ceiling on the interest on deposits made for a period of more than a year; thus the possibility of directly regulating the interest level of deposits also came to an end. The roles of the basic interest rate and the refinancing interest rate were taken over first by the yields realized in the market in which deficiency bills are sold by auction (organized by the NBH), and, later on, by the interest rates applied in repurchasing (repo) agreements.

Beside the rapidly growing issue of state papers and their dominance in the capital market, the interest rate level in this market more and more came to be determined by the yields of these papers. From 1991 on it was apparent that the banks had adjusted their deposit interest rates—albeit with some delay—to the yield of state papers having similar durations of maturity. Also, the yields developing in the discount market for state papers (organized by the NBH) were dependent on the financing requirements of the budget rather than on considerations of mon-

etary policy. Thus, in the last analysis, the interest rates were influenced not by the financial policy of the central bank but much more by budgetary policy.

The scope for altering the interest policy of the NBH was narrow, for several other reasons. Beside the open character of the economy, an exchange rate which behaves as a fixed exchange rate, coupled with inflationary expectations, restricts the possibilities for issue bank to set independent objectives for its interest rate policy. Owing to the pressure of the government, the NBH walked into this trap in 1992–93 when, for the sake of vivifying the economy, it attempted to implement an interest-reducing policy. The aim of reducing interest rates came into conflict with the growing sales of state papers as well as with an exchange rate policy which was attempting to avoid a real devaluation of the forint. (The correction happened in the summer and autumn of 1993; this was, however, already not enough to reverse the decreasing trend of savings.) In the wake of the failures of the interest rate policy, the NBH modified its target system from 1994. With this modification it wishes to avoid following the objectives of the interest rate policy and in doing so will replace them with quantitative aims.

Parallel with the liberalization of foreign exchange and the imports, from 1990 onwards the *exchange rate policy* became an active monetary instrument. The primary aim of the active exchange rate policy (which supplants automatic devaluations and follows the rate of inflation—i.e. the inflationary differences), was to restrain inflation. However, the argument was also put forward that an indifferent or revaluing exchange-rate policy also stimulates restructuring, because it encourages import competition. The devaluation of the real exchange rate of the forint exerted—partly and gradually—an effect on the profitability of the companies. This was a result of their poor competitiveness and this became more obvious when restrictions were placed on subsidies. From 1990 on, the strengthening real value of the national currency was promoted by the favourable development of the balance of payments and, within it, the powerful capital inflow.

The NBH policy involving the adjustment of exchange rates, until the end of 1993, focussed on the industrial producer price index. However, the development of the real exchange rate, owing to the peculiarities of the Hungarian cost and price structure, markedly differed from the real exchange rate indices. The latter were based on changes in both the consumer price index and the labour cost per production unit. For this reason the real exchange rate was either maintained at its current level, or slightly revalued. This reflected, in certain segments of the economy, a somewhat more revalued forint exchange rate.

The foreign exchange market among the banks was opened in 1992 and the gradually widened margin for intervention served the development of the exchange-rate policy. The aim of this was to change over from the system of fixed exchange rates to a more flexible system, reflecting the relations of supply and demand. The NBH, however, applied the intervention in the foreign exchange market in a dysfunctional way, in opposition to the logic of the market. (For instance, this

happened in the autumn of 1993, when it devalued the forint simultaneously with raising the interest rate.)

The factor that was the most contrary of all to the modernization of monetary regulation was that in which the NBH could not give up regulating the money supply *by prescribing the formation of obligatory reserves*. What is more, as a result of repeatedly raising the reserve rate and its basis of calculation, the actual rate of reserve increased to its multiple between 1988–1993 (from 4 to 14 percent).

The reserve rate—as against its classical function—was applied by the NBH as an operative tool for regulating liquidity. This was because the usual instruments—i.e. interest rate policy and open market transactions—were insufficient. Owing to the unstable environment of regulation, the banks were dependent on the reserve rate policy of the central bank, rather than on the actual processes of the money market.

The central bank, however, used the reserve rate policy not only for liquidity regulation but, at least to the same extent, for compensation for the low interest rates on the issue bank credits granted to the budget. Namely, in addition to the fact that increases in the obligatory reserves narrowed down the opportunities of the banks to create money, the application of the high reserve rate also served the redistribution of incomes between the banks and the budget. The high rate of reserves allowed the NBH to counterbalance the income fall-out (brought about by the financing of state debts) by using the savings arising from the low interest paid on bank reserves.

The described income transfer resulted in the growth of the interest margins of the banks, for they had to turn their losses on credits (brought about by the high reserves) into credit interest. (This, in 1991–92, beside the nominal interest level of about 30 percent, reached 3–4 percentage points.) Up to the early days of 1992, due to the fact that the banks, in the competition for sources, were unable to reduce the interest on deposits, they had to increase the interest on less interest-sensitive credits. This was in order to compensate for the decline in the incomes originating from the obligatory reserves. It is, however, not by chance that the obligatory reserve policy of the NBH from the second half of 1991 came into conflict with the interest rate policy implemented for the purpose of stimulating the economy. In addition to this, the burdens of the reserve funds for risks were increased and, owing to the growth of the banking risks and the bad debts, the high level of the obligatory reserves also became obstacles. This made it impossible to reduce the issue bank interest rates such that they would bring down the interest rates of bank credits.

The banking policy of the government

The greatest failure of the modernization process carried out in the monetary system so far has been the adverse development of the system of commercial banks: the present government has made its condition worse than it was when it assumed power. This is true with regard both to its ownership structure as well as its financial situation. In this, and alongside the worsening general situation of the economy, a part was also played by the fact that the government did not develop a well-considered policy for the stabilization of the banking system. As a result, the measures taken were late and had a "fire-fighting" character, rather than that of a well-planned process. In addition, the short-term interests of political power often prevailed over the interest of creating an efficient and stable banking system.

Yet stabilization of the banking system and the expansion of its efficiency should have been treated as one of the most important steps in changing over to a market economy. The two basic conditions for this were the transformation of the inappropriate ownership structure (i.e. breaking down the dominant state property of the big banks), and—simultaneously—the improvement of the inadequate capital structure and portfolios of the banks. The Antall-Boross Government, within the four years that have been available to it, have solved neither of these two important and interconnected tasks. Although the government made some attempts—with dubious results—to solve the problems of the capital structure, it paid hardly any attention to changing the ownership structure, and when it did it was too late.

The ownership policy: the "strategy" of nationalization before privatization

Although both the spirit and the letter of the law on banking institutions equally suggest that the government will soon radically reduce the share of state property in each of the banks in question, over a period of two years there have been no signs of such endeavours.

In the period since the birth of the law on banking institutions, the proprietary interventions in the banks' operations, instead of having decreased, have considerably grown. The first reason for this was that the bank assemblies which exercised the right of voting associated with the shares owned by the state enterprises were seized. In other words, there was a concentration on behalf of the representative of the state (first the State Property Agency, later on the State Holding Co.). In addition, the increase in capital due to the actions of the state in the course of bank consolidation markedly increased (in its third form of appearance it was represented by the Ministry of Finance) the proprietary influence of the state in the eight banks concerned. Thus, by the end of 1993, in a majority of banks, the share of direct state ownership grew to more than 75 percent.

In terms of the policy on state enterprise property, property management, and bank consolidation, the government has markedly increased its role as a proprietor, but it has not done much to bring about the privatization of the banks. With its delaying policy it has missed the opportunity which was presented to it in 1990–91; namely, to involve foreign professional investors as proprietors in the ownership of the big commercial banks.

Thus one of the creations of the government which goes to the elections in the middle of 1994 will be a banking system which has a greater share of state property and is more centrally controlled than it was when it took over. In the course of the last four years the share of state property has almost doubled (from 38 to 70 percent).

Measures taken for the consolidation of the banking system

Since 1991 the operation of the banking system has been increasingly impeded by the excessively high proportion of bad outstanding debts within the banks' assets. The unfavourable ownership structure has also contributed to the fact that the quality of the banks' outlays has not been made any better since the beginning of the bank reform. What is more, the stock of qualified active debts has increased as a result of the collapse of companies and of the more strict order of accounting. Also, by the end of 1992, such debts had reached one-fifth of the summarized amount of all bank credits.

The banks' own capabilities for coping with their credit portfolios have proved to be inappropriate. Since the banks were allowed to form a reserve fund of risks for the qualified active debts (to the debit of their cost accounts from December 1991) the level of reserves was too low for getting rid of the bad debts without a considerable loss of capital. This was the reason why the state could not avoid taking on the role of clearing the capital market and restoring the operating capacity of the banking system. This was reflected in the governmental work which was started in order to implement the so-called "credit consolidation", aimed at clearing the bank balance sheets in two phases.

a) Credit consolidation

The effect of the exchange of bonds within the credit consolidation which was aimed at improving the balance sheets for 1992, was that in these balances the ratio between the reserve funds prescribed and actually formed (the filling up of the reserve funds) grew by several percentage points. Credit consolidation in the balance sheets of 1992 considerably increased the guaranty capital and thereby, as

well as reducing the losses, raised the capital adequacy indices to a higher level. However, in most banks this favourable effect soon disappeared. Owing to the rapid growth of bad debts, within half a year, the new demand for making reserves came into being and this was equal to the amount released for the consolidation. As a result of the multiplying bad credits, it was not only the chance of achieving the stipulated level of capital adequacy that became reduced to nothing, but the shortage of guaranty capital also grew day by day.

The revision of the system (i.e. "softening" of the originally stipulated conditions) came to pass due to the recognition of the problems of the introduced arrangements. The obligation to pay a consolidation fee was cancelled and the state bonds of lower yield, received for the interest, were replaced by others issued with better conditions. The revision of the original decision improved the situation of the banks in question. The indecision of the government with regard to this matter increased, and at the same time so did the uncertainty linked to the consolidation and development of the banking system. This had an unfavourable influence on both the bank managements and those who were potential investors for the banks. The procrastination of credit consolidation and the lack of a definite government conception made the leaders of the banks in question not so much interested in the most effective operation possible, but in the strengthening of their bargaining position against the government. Also, for the investors interested in the banks the hesitation of the government created an incomputable situation, for under such conditions the advantages and disadvantages stemming from purchasing the banks could only be calculated with great difficulty (if at all).

Almost nothing happened in 1993 to the active debts which, in the course of credit consolidation, came into the portfolio of the Hungarian Bank Supervision (with regard to a part of which it has made contracts with other groups who then manage them, while it has kept the other part in its own hands).

b) Bank and debtor consolidation

Based on a proposition made by experts of international banking institutions, in 1993 the government returned to the conception according to which it is regarded as expedient to manage the problem of bad portfolios *by raising the banking capital*. This method starts out from the idea that the problem is seen as one in which there is low guaranty capital of the banks in relation to their credit risk. Therefore the government grants to the banks a capital injection, and with this the capital adequacy index of the banks in question can grow by at least 4 percent. The expectation linked to this idea is that afterwards, with capital-raising privatization, the capital adequacy index of the banks can attain the level of 8 percent stipulated by the law on banks presently in force, and by the directives of the EC.

In the first stage of capital raising the objective was set to reach a 0 capital adequacy index. This required a capital injection of 112 billion forints in the eight elected banks. At that time consolidation extended not only to the credits but also to the bank investments and the guarantees granted by the banks. The capital was raised in the form of state bonds; thus in 1993 it required no budget expenditure. From 1994 on, however, the investment burdens are charged on the budget. The total amount of interest, including the interest on the 1992 credit consolidation bonds, may be estimated at about 40–50 billion forint.

In the course of bank consolidation the bad outstanding debts and investments have remained in the banks' portfolios. At the same time a *debtor consolidation*—the process and outcome of which is, for the time being, uncertain—has also been linked to the raising of bank capital. The actual process of this and the roles taken on by the banks have markedly influenced the chances of improving the bank portfolios. In return for the raising of capital granted by the state, the banks concluded a contract with the Ministry of Finance (representing the state) according to which the banks will participate in the debtor-consolidating action controlled by the state. Accordingly, the debtors in possession of a loan that is qualified as problematic by one of the banks participating in the consolidation—in the case of elaborating a satisfactory reorganization programme—may make a claim for a conciliatory procedure.

However, the rational implementation of reconciliatory procedures and the assertion of the bankers' viewpoints would probably be delimited by the fact that the direct proprietary share of the state would be considerably increased in the banks concerned. (In the three biggest banks the share of direct state property has grown to a level between 78–90 percent.) The high degree of nationalization makes it possible for the interest on the debtor consolidation accepted by the government to appear in the management of banks in the form of a direct pressure; consequently, the purely banking viewpoints may be neglected in the reconciliation procedures. For this reason, in the decisions on debtor consolidation the business interests based on market perspectives and profitability may be pushed into the background for political reasons. All this may render it possible that in the near future new elements of state consolidation will emerge.

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From the aspect of stabilizing the banking system the measures of bank- and credit consolidation taken so far may be considered as actions of a fire-fighting character. In other words, these measures appear to represent the monetary treatment of the portfolio and capital problems which have evolved up to now. Since the credit consolidation of 1992 raised no requirement whatsoever against the leadership of banks, there was no guarantee that, in return for the significant burden that the state had taken over, the decisions made by the banks would grow better. The pro-

prietary structure of the banks with partially cleared portfolios was not improved in the course of the one-year period following the consolidation, and there was not even any partial privatization.

The bank consolidation contracts, made at the end of 1993, prescribed certain commitments to the bank managements and these were intended to improve the banking operations: the banks have to draw up a consolidation programme which covers the development of the respective bank's strategy, of its cost management, of its rationalization the organization plans, as well as dealing with its plans for improving the system of qualification and credit appraisal. The implementation of the consolidation programme will be controlled by those bank managements in which the state (government) has an unlimited voting right. The same government has, however, started a debtor consolidation campaign which, if carried out to everyone's satisfaction, restricts the possibility of making bank-like decisions. Therefore, it is fair to say that the realization of the bank consolidation programme has been put in jeopardy.

For instance, while the government spent more than 300 billion forints in 1993–94 on consolidating credits and banks, it granted no guarantee which would assure that the bank activities would get better and that the improved portfolios and capital would not deteriorate again within a short time.

Monetary policy: stabilization successes and failures

Since 1990, monetary policy has been manoeuvring within the threefold system of anti-inflationary intentions, endeavours at improving external equilibrium, and—from 1992 on—attempts to enliven the economy. The NBH was basically motivated by equilibrium-improving objectives. At times these were in harmony with, and at other times in opposition to, economic policy. The endeavours aimed at improving internal and external equilibrium involved, from the outset, several contradictions in themselves. These problems grew worse still due to the problems associated with the monetary instruments that were applied. This explains why the harmony between the intentions and results has not grown better.

Monetary policy in the period between 1990–1993 can be broken down into two phases. Up to the end of 1991 the aims of achieving equilibrium were unequivocally dominant in monetary policy. From 1992 on, along with the changing trend of economic policy, ever greater emphasis was laid on vivifying the economy and, together with it, on reducing the level of interest rates. The results, however, did not always reflect the intentions. This was due partly to some effects from outside the monetary sphere, and partly to the protracted influence of the monetary tools.

The Antall Government took over the economy in an unstable condition. The equilibrium position in 1989 was fairly adverse: the deficit in the balance of

Table 1

Key financial indicators (in percentage)

	1989	1990	1991	1992	Jan.–Sept. 1993
Growth over previous year					
–Change in the stock of domestic credit	16.2	11.1	7.4	10.4	9.2
–Change in the stock of money	14.0	28.7	28.7	27.4	10.2
–Rate of inflation	17.0	28.9	35.0	23.0	16.9
–Nominal change in the GDP	21.0	21.2	11.3	21.6	n.d.
Stock of money in percentage of GDP	41.5	44.0	50.9	53.4	n.d.
Cash in hand in percentage of stock of money	25.5	23.1	22.2	21.6	21.0

Source: yearly and monthly reports of NBH

Table 2

Hungary's external equilibrium
(Accounted in convertible currencies, in millions of dollars)

	1989	1990	1991	1992	Jan.–Sept. 1993
Foreign trade balance	537	348	189	-48	-2545
Current account balance	-1,437	127	267	324	-2656
Foreign direct investment	187	311	1459	1471	943
Gross national debt	20,390	21,270	22,658	21,437	23,953
Debt service (percentage)	38.5	43.2	32.0	31.9	n.d.

Source: yearly and monthly reports of NBH

payments, despite the active balance of USD 500 million, amounted to 1.4 billion USD. In addition, the level of foreign exchange reserves was dangerously low—altogether not more than 1.7 billion USD (i.e. equal to the amount of three months' imports); the gross debt stock was 20.3 billion USD and its maturity structure was also unfavourable (the share of short-term debts was 16 percent). The indices of the internal equilibrium situation were also relatively favourable: the rate of inflation was 17 percent, the economy had a real growth rate of 4 percent; the budgetary deficit amounted to 3 percent of the GDP and there was practically no unemployment.

1990 was a "mixed" year, determined basically still by the policy of the Németh Government. At that time, due to something bordering on a power vacuum, the external equilibrium actually improved, but the internal tensions were growing. This trend continued until the autumn of 1992: *The successes of the ex-*

ternal economy were accompanied by domestic destabilization. In 1993 the situation continued to worsen, because the rapid regression of the foreign economic position came about with no internal stabilization.

The initial transitory foreign economic successes of the market economy were soon undermined by the processes which began in the autumn of 1992. In the second part of this year the dynamism of the exports started to break down and then rapidly decline in 1993; at the same time imports continued to grow. In the first half of 1993 the current balance of payments showed a deficit of 1.8 billion USD. This grew to 3.1 billion USD by the end of the year. The problem worsened due to the fact that, in addition to the slowdown of the tendency towards a growth in savings, the increasing indebtedness of the state entailed significant rises in interest rates. Alongside all this the decreasing trend of inflation also ceased, and in fact inflation began to grow. The emphasis on exports exerted pressure on the anti-inflationary exchange-rate policy, while—under other unchanged conditions—its positive effect on external equilibrium was also ambiguous.

Almost all the indicators characteristic of the *equilibrium of the domestic economy* markedly deteriorated between 1990 and 1993. The rate of inflation, after the cessation of the transitory effects of the transformation (i.e. due to the termination of the subsidies and liberalization) was still very high, but it seemed to be stabilized between 20–25 percent. Alongside the reduction in the inflation rate in 1992 there were contributory factors which could not be maintained for a long period, nor would it have been wise to do so. The most important of the unfavourable anti-inflationary effects was the exacerbation of the economic recession. However, the revaluing of the real exchange rate with the aim of putting a brake on the inflation was negligible; on the other hand, it exerted a disadvantageous influence on the balance of payments. Probably the laws on bankruptcy and on accounting also had a non-recurrent restricting effect on inflation.

Even the rapid growth of savings, which had a beneficial result on the decline of inflation, has come to an end, and no economic policy was able to prevent this. The sudden leap in the savings' rate between 1989–1992 was a non-recurrent process which accompanied the strengthening of the financial economy.

From 1990 onwards, the savings' rate, measured in comparison to the available incomes, rose to a multiple of the value at which it had stood in years prior to that. The net savings of the population (reduced by the loans borrowed) also began to grow in a measure significant even considering the real value. In 1991 they doubled (to 647 billion Ft) and in 1992 increased by 42 percent (to 919 billion Ft). The increasing trend stopped in 1993, when the real value of the population's savings declined by about 3 percent.

The growing propensity to save in the period 1990–92 can be put down to the following:

Table 3

Savings by the population

	1989	1990	1991	1992	Jan.–Nov. 1993
Stock of savings (in billion forints)					
Gross savings	474.9	584.4	781.7	1044.7	1222.9
Credits drawn from the banks by the population	313.5	330.0	205.6	212.7	241.3
Net savings	161.4	254.4	576.1	832.0	981.6
Change in stock of savings (in percentage)					
Gross savings	4.9	23.1	33.8	33.6	17.1
Net savings	3.3	57.6	126.5	44.4	18.0
Change of stock in real value (in percentage)					
Gross savings	-12.1	-5.8	-1.3	12.0	-2.4
Net savingss	-13.7	28.7	91.4	22.8	-1.5

Source: yearly and monthly reports of NBH

— strengthening competition in the banking system. The growing competition increasingly adjusted the interest to the rate of inflation. Consequently, in 1991–92 the loss in the value of deposits tied up for a year diminished;

— besides high inflation, there was an increase in the demand for money needed for making transactions, as well as in the keeping of money. Owing to high inflation cash which was kept increasingly lost its value; thus this practice was gradually replaced by forms of saving which, beside providing good liquidity, at the same time also produced a certain yield (deposits, bonds, treasury notes);

— the improving consumer market and the cessation of the earlier shortage of goods was brought about by import liberalization; these facts, along with the growing liquidity constraint on companies, elicited a positive influence on the propensity to save;

— the strengthening of social uncertainty;

— the declining yield of real investments, which resulted in a shift of savings towards monetary savings.

Not only the savings of the population but also those of companies increased strongly in the early nineties. In the period between 1989–1992 the stock of company deposits increased in real value by 22 percent. This was partly the result of the strengthening constraint of liquidity and partly of the fact that the money deposits produced a higher yield than the capital investments. However, in 1993 the growth came to an end: the company deposits decreased by about 6 percent in real value.

In the fall of savings in 1993 the mistakes of economic policy also played their part. The chances of another period of rapid growth of saving are unlikely unless a more adequate policy is adopted.

The danger of persistently ***high inflation*** has still not passed, even in the period following the rapid reduction of subsidization. Nevertheless, its growth was successfully stopped and, by the modernization of the economic laws, a good number of stabilizers could be built into the development of the price level. Despite the circumstance that it seems that there will be no dramatic growth of inflation, a permanent high (20 percent) inflation seems likely, owing to the significant and rapidly growing deficit of the state finances and state debts. The export-promoting policy has been made necessary because of the deficit in the balance of payments. The latter has increased to a critical level, and it is also another inflation-producing factor to be coped with in the coming years.

Thus, over a period of three and a half years the Antall Government has *failed to stabilize the financial situation of the economy*. In addition to the objective difficulties of the transitory period, there is no doubt that deficiencies in economic policy also played a role; this includes the failures of monetary policy which occurred in 1992–93. Despite the autonomy granted to the NBH, the efficiency of monetary policy was strongly hindered by some measures of the government, and the unpredictable reactions of some of the participants in the economy.

Parallel with the growing activity of money and the efficiency of the control of the supply of money, the effectiveness of monetary policy with regard to anti-inflationary objectives was affected by different factors. At the beginning of the government's term delayed payments and queuing of enterprises produced a growth of the rate of inflation. This was higher than it had been due to the quantity of money created by the banking system. In addition, from 1990 onwards, the need to finance the rapidly increasing state debts exercised greater pressure on the money market.

As we have seen, the contradictions in the regulation pursued by the issue bank also contributed to the moderate success of the monetary policy. The NBH managed to serve the objectives of internal equilibrium with its exchange rate policy, but its interest rate policy was not always adjusted to the requirements of equilibrium. It took on a most contradictory role in 1992–93 when its main objective was to reduce interest rates; this was at a time when the general economic environment was unfavourable both for savings and capital investments. This policy took place in circumstances involving extremely high risks, and it was unable to revive the economy; thus the development of negative real interest on deposits repressed the propensity to save. This situation, beside the increasing deficits of state finances, brought about a serious threat with regard both to inflation, and to the stock of external debts.

The way out from the dangerous instability of the financial equilibrium (which is going to be left behind by this government) can perhaps be helped by favourable changes in the behaviour of the participants of the economy. These are already apparent in an embryonic form, such as the growing sensitivity to monetary signals both in households and enterprises. Furthermore, in the wake of the law on

bankruptcy, there has been a tighter attitude, with restrictions being placed on company budgets; both can be observed, partly in the growth of financial savings and the revaluation of liquidity, and partly in the diminishing hunger for investments. The favourable, though for the time being, frail change of company behaviour may easily be (and is already being) undermined by irresponsible commitments being taken on by the government (e.g. by proclaiming a programme for debtors' consolidation). This suggests the revival of the paternalistic inclination of the state (especially the state banks), and raises a serious issue to be dealt with by the next government.

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INDIVIDUAL TIME ALLOCATION
A Labour Supply Model

P. GALASI

The study in this paper is the first attempt to estimate labour supply models for a sample of Hungarian individuals. A static individual labour supply model with seven activities is presented. We examine the effects of wage rates, non-labour income, and the time costs of working on the supply of different kinds of labour. First-order optimality conditions as well as comparative statics are derived and the model's empirical validity is tested with the help of a three-stage procedure. The performance of the model turned out to be as reliable as that of similar labour supply estimations. The most important result was that in the case of significant parameter estimations an increase in the wage rate decreases labour supply and thus the income effect is stronger than the substitution effect.

Introduction[1]

Labour supply models have been an integral part of labour economics for at least two decades.[2] A possible formulation of the problem involves constructing individual static labour supply models where supply is defined in terms of working hours per time period, and the main question is to determine the factors influencing time allocation between different paid and unpaid activities. In this paper we will distinguish work in the main job under normal working time, overtime in the main job, work in a second job, household work[3] and work on household plots. We also include the time cost of paid work.[4] This is not the only method of labour supply analysis; in addition to individual static models there exist individual dynamic and family models, too.[5]

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[1]Financial support from the Sociology of Value Workshop, the Institute of Sociology of the Hungarian Academy of Sciences is acknowledged. I thank Gábor *Kertesi* for his remarks and advice.

[2]For good summaries of this line of research see *Killingsworth* (1983), *Killingsworth and Heckman* (1986), *Pencavel* (1986).

[3]With reference to household labour supply see *Gronau* (1986).

[4]With reference to the labour supply with fixed costs see *Cogan* (1980).

[5]For a similar two-earner-family labour supply model see *Solberg and Wong* (1992).

The model[6]

In this model, individuals may allocate their time across seven activities: normal working hours in the main job (H_f), overtime in the main job (H_t), work in a second job (H_m), household work (H_h), work on the household plot (H_k), time of travel to paid work (H_u), and leisure (L). Fixed time cost will be considered exogenous.

We assume that individual's utility (U) is a non-decreasing function of the services and goods produced in the household and bought in the market (X), and of the leisure time. It is also assumed that individuals consume all their income as well as the goods and services they produce (savings and loans are excluded). Households and the technology applied to household plots are described by the following production functions: $X_h = f(H_h)$ and $X_k = g(H_k)$. Both are increasing in their argument and the marginal product of working time is decreasing. The real income (consumption) of the individual per time period is then $X = \sum X_i$ ($i = h, k, M$, where M is the goods bought in the market). The time constraint can be written as $T = H_f + H_t + H_m + H_u + H_h + H_k + L$ (where T is the total time per time period). The budget constraint, with a market prices setting equal to 1, is $X = \sum W_j H_j + g(H_k) + f(H_h) + V$, where $W_j (j = f, t, m,)$ is the wage rate, and V is non-labour income.

Individuals maximise their utility subject to two constraints. Thus:

$$\max U(X, L) \tag{1}$$

subject to

$$T = \sum H_i + L \qquad (i = f, t, m, u, h, k), \tag{2}$$

$$X = \sum W_j H_j + f(H_h) + g(H_k) + V \quad (j = f, t, m). \tag{3}$$

Form the Lagrangian:

$$L = U(X, L) + \lambda_1 (T - \sum H_i - L) + \lambda_2 (\sum W_j H_j + f(H_h) + g(H_k) + V - X) \tag{4}$$

$$(i = f, t, m, u, h, k,\ j = f, t, m),$$

The first-order conditions for an optimal time allocation become

$$U_X - \lambda_2 = 0 \tag{5}$$

[6] For similar individual labour supply models see *Merz* (1989), *Shisko and Rostker* (1976).

$$U_L - \lambda_1 = 0 \tag{6}$$

$$\lambda_2 g' - \lambda_1 = 0 \tag{7}$$

$$\lambda_2 f' - \lambda_1 = 0 \tag{8}$$

$$\lambda_2 W_i - \lambda_1 = 0 \quad (i = f, t, m), \tag{9}$$

where U_X and U_L are marginal utilities of consumption and leisure, and g' and f' represent the marginal product of the household work and work on the household plot, respectively. After rearrangements we arrive at:

$$U_L/U_X = f' = g' = W_i \quad (i = f, t, m). \tag{10}$$

The left-hand side in (10) is the shadow price of leisure or the marginal rate of substitution between consumption and leisure. The individual selects the number of hours to be spent on household work and/or work on the household plot so that the marginal product of these activities be equal to the marginal rate of substitution. If no time allocation exists at which this equality holds—that is, if the marginal productivity of these activities is lower at any hour of work than the marginal rate of substitution—then individuals will not work in the household and/or on the household plot. They will also decide on the length of their paid work. They select a positive working time in the main job if there exists a time allocation at which the wage rate is higher than the marginal product of both household work and work on the household plot, and then they will select the number of hours in the main job so that the wage rate be equal to the shadow price of leisure. If, at any hours of work, the marginal product of household work and/or work on the household plot is greater (less) than the wage rate in the main job they will not work for pecuniary remuneration (in the household and/or the household plot). The same holds for overtime work and work in a second job.

The Beckerian full-income/full-expenditure equality is as follows:

$$W_i L + X = f(H_h) + g(H_k) - W_i(H_h + H_k) + W_i(T - H_u) + V \equiv I \; (i = f, t, m), \tag{11}$$

where I is the full income. The profit from household work and work on the household plot can be written[7] as

$$f(H_h) + g(H_k) - W_i(H_h + H_k) = \pi \quad (i = f, t, m). \tag{12}$$

[7] This formulation is due to *Solberg and Wong*.

Now we can derive the comparative statics of the model. As for the household work and work on the household plot, we assume that the individual behaves as a small firm in a competitive market, therefore $\partial H_h/\partial W_i < 0$ $(i = f,t,m)$ and $\partial H_k/\partial W_i < 0$ $(i = f,t,m)$. Then an individual's labour supply will be

$$H_i = H_i(W_j) \quad (i = h,k,\ j = f,t,m). \tag{13}$$

From (12) and (13) we get (14):

$$\pi(W_i) = f(H_h(W_i)+g(H_k(W_i)-W_i H_h(W_i)-W_i H_k(W_i) \qquad (i = f,t,m). \tag{14}$$

As for the consumption of leisure, in the case of non labour income and fixed time cost we have a pure income effect. From (6), (11) and (14) we arrive at

$$L = L(W_i, I(W_i, H_u, V)), \tag{15}$$

and $\partial L/\partial H_u = (\partial L/\partial I)(\partial I/\partial H_u) < 0$, $\partial L/\partial V = (\partial L/\partial I)(\partial I/\partial V > 0$.

The effect of the wage rate on leisure time can be written as:

$$\frac{\partial L}{\partial W_i} = \left(\frac{\partial L}{\partial W_i}\right)_s + \frac{\partial L}{\partial I}\frac{\partial I}{\partial W_i} \qquad (i = f,t,m), \tag{16}$$

and using (11) and (12) we arrive at

$$\frac{\partial I}{\partial W_i} = \left(\frac{\partial \pi}{\partial W_i}\right)_s + (T - H_u) \qquad (i = f,t,m), \tag{17}$$

finally, by using (16) and (17) we have

$$\frac{\partial L}{\partial W_i} = \left(\frac{\partial L}{\partial W_i}\right)_s + (T - H_u)\frac{\partial L}{\partial I} + \frac{\partial \pi}{\partial W_i}\frac{\partial L}{\partial I} \qquad (i = f,t,m). \tag{18}$$

The first and second terms in (18) are the substitution and income effects; they are negative and positive, respectively. The third one is the effect of wage rate on the profit. From (14) we know that this is negative, for an increase in the wage rate decreases the time spent on household work and with work on the household plot, and therefore it reduces the profit. The third term is then negative. Thus, it is an empirical question whether the overall effect will be negative or positive.

Finally, consider the time spent on paid work. After rearranging the time constraint we have:

$$H_i = T - L(W_i, I(W_i, H_u, V)) - H_h(W_i) - H_k(W_i) - H_u. \tag{19}$$

From (19) we can determine the effect of non labour income, fixed time cost and own wage rate on the supply of paid labour.

$$\frac{\partial H_i}{\partial V} = -\frac{\partial L}{\partial I}\frac{\partial I}{\partial V}, \tag{20}$$

$$\frac{\partial H_i}{\partial H_u} = -\frac{\partial L}{\partial I}\frac{\partial I}{\partial H_u} - 1, \tag{21}$$

$$\frac{\partial H_i}{\partial W_i} = -\frac{\partial L}{\partial W_i} - \frac{\partial H_h}{\partial W_i} - \frac{\partial H_k}{\partial W_i}. \tag{22}$$

An increase in non labour income reduces the time spent on paid work (see (20)). The effect of the fixed cost of working cannot be theoretically determined ($\partial L/\partial I$ is positive, $\partial I/\partial H_u$ is negative, then the first term on the right-hand side in (21) is positive), and we have the same result in the case of own wage rate. The first term on the right-hand side in (22) might be both positive and negative (see (18)), and the second and third terms are negative.

As for the effect of a wage rate on the labour supply of another paid activity, it can be written as:

$$H_i = T - L(W_j, I(W_j, H_u, V)) - H_h(W_j) - H_k(W_j) - H_j(W_j) - H_u \tag{23}$$

$$(i, j = f, t, m,\ i \neq j),$$

thus

$$\frac{\partial H_i}{\partial W_j} = -\frac{\partial L}{\partial W_j} - \frac{\partial H_h}{\partial W_j} - \frac{\partial H_k}{\partial W_j} - \frac{\partial H_j}{\partial W_j}. \tag{24}$$

From (18) and (22) we know that the first and last terms in (24) might be both positive and negative, and that the second and third terms are negative. Thus we cannot theoretically predict the sign of (24).

Data, variables, estimation procedure

The data are from a survey considered representative for Hungarian households, conducted in 1987 by the Institute for Social Sciences of the Central Committee of the Hungarian Socialist Workers' Party. The sample consists of 1143 households. A detailed time-use report is available for two adult (older than 17 years) members of each household.[8] These persons are mostly household heads

[8]I thank Endre *Sík* for providing access to data as well as Anna *Boros* and Zsuzsa *Hunyadi* for their help in data processing.

and their spouses. Our units of observation are individuals with detailed time-use data. Originally the sample has consisted of 1972 individuals. We have excluded 23 individuals from the analysis because of missing and/or logically unsound and/or contradictory data. Time-use variables are for an average work day or work week. I have computed and used daily work time variables. Wage rates are not available but we know net monthly incomes from different activities. I have computed average wage rates for each paid activity by making use of work hour variables and assuming 21 work days per month. Non-labour income consists of transfers (pensions, child allowances, grants etc.) and the labour income of other family members.

To capture the heterogeneity of the individuals the usual human capital and socio-demographic variables (gender, occupational status, schooling, age, work experience, family size, the number of active members and pupils/students in the family) are included.

In estimating work hours we use Heckman's probit and a three-stage procedure.[9] First, with the help of probit analysis for each activity, we compute selection correction variables (λ). Second, by running selectivity-bias-corrected OLS regressions with the (natural log of) wage rates as dependent variables, we get imputed wages for the third stage. Third, we estimate labour supply functions with imputed wages and selection correction variables as independent variables.[10]

Estimation results

Work hour estimations are reported in *Table 1*. The results of probit and wage equations are shown in the *Appendix*. Similarly to most labour supply estimations, the value of multiple determination coefficients are quite low (except for household work). This tells us that the explanatory power of static labour supply models in terms of the explained portion of variation in dependent variables is relatively weak.

Firstly, the selectivity-bias hypothesis seems to be justified because we have significant coefficients for the selection correction variables (except for the second-job-work-hours equation). Second, the estimation of non-labour income proved unsuccessful; no equation has a significant coefficient. As for the fixed time cost of work (H_u), its coefficient is negative and significant (except for second job and household plot equations). In the case of household work this result contradicts

[9] For different estimation procedures see *Killingsworth* (1983) pp. 131–168. We are using *Procedure VIII*.

[10] A further complication is that the disturbance term is heteroscedastic in the second and third steps (see *Greene*, p. 746). We have dealt with this problem by using *White's* heteroscedasticity-consistent covariance matrix (see *White* 1980).

Table 1

Estimations of labour supply

Variables	Main job, normal working time (H_f)	Main job, overtime (H_t)	Second job (H_m)	Household work (H_h)	Work on household plot (H_k)
$\ln W_f$	-.36 (1.41)	.05 (.26)	.15 (.38)	-1.63 (7.03)	-1.18 (5.75)
$\ln W_t$	-.64 (2.19)	-.005 (.01)	.33 (.94)	.18 (.62)	.15 (.36)
$\ln Wm$	-.11 (1.71)	.006 (.13)	-.39 (1.32)	-.12 (1.93)	-.02 (.27)
V (10^{-5})	-1.75 (.53)	-1.18 (.33)	3.04 (1.16)	-.19 (.09)	-.93 (.72)
H_u	-.19 (2.26)	-.17 (2.63)	.02 (.24)	-.30 (4.84)	-.12 (1.57)
Age	.11 (1.89)	-.04 (.75)	-.03 (.90)	.10 (.67)	.07 (1.88)
Age^2	-.001(1.52)	.006(1.05)	.004(1.09)	-.001 (.50)	-.002 (.93)
No. of family members	.30 (3.26)	.18 (2.57)	-.02 (.25)	.66 (10.09)	.14 (2.01)
No. of active members	-.30 (3.25)	-.24 (2.82)	-.04 (.40)	-.29 (3.62)	-.08 (.91)
No. of pupils/students	-.39 (4.50)	-.18 (2.49)	-.17 (1.92)	-.50 (6.16)	-.15 (2.04)
λ	.62 (4.17)	1.51 (4.16)	.86 (1.45)	2.13 (22.90)	.99 (5.00)
Constant	10.85 (9.05)	.48 (.35)	1.99 (2.01)	1.59 (1.34)	3.10 (2.95)
Adjusted R^2	.04	.05	.07	.38	.09
F value	3.66	3.07	4.28	101.58	13.01
log-likelihood	-2330.88	-551.61	-668.89	-3799.51	-2824.42
(t-values in parentheses)					
N	1231	459	460	1781	1038

the prediction of the theoretical model (see (13)). *Solberg and Wong* (pp. 502–503) have a similar result. It is perhaps possible to handle this problem by considering time costs of work to be endogenous. As for the own-wage effects on market labour supply (regular hours in the main job, overtime, second job) we have no significant coefficients. In the case of cross-wage effects two coefficients are significant and negative: an increase in overtime and second job wage rates decrease regular work hours in the main job. The effects of wages on non-market labour supply are as predicted by the theoretical model: where coefficients are significant their signs are negative. This holds true for both main job wage rates in the household work hours equation and also for the regular work hours wage rate of the main job in the household plot work hour equation.

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Table A1

Estimation of participation in market and non market work (Probit)

Variables (N)	Main job, normal working time (1231)		Main job, overtime (459)		Second job (460)		Household work (1781)		Work on household plots (1038)	
Male	.64	(6.42)	.24	(3.19)	.45	(6.43)	-1.28	(10.1)	.73	(10.4)
Schooling	.27	(3.62)	-.03	(.51)	-.10	(2.08)	.10	(1.76)	.12	(2.63)
Schooling^2	-.005	(1.55)	.004	(1.50)	.007	(3.02)	-.003	(1.01)	-.008	(3.74)
Unskilled			.21	(1.37)	.08	(.61)	-.12	(.74)	-.17	(1.50)
Semi-skilled			.43	(3.07)	.19	(1.64)	.04	(.25)	-.09	(.82)
Skilled			.43	(3.71)	.12	(1.18)	.03	(.21)	-.20	(1.96)
Other manual			.08	(.59)	.11	(.92)	.46	(1.81)	-.17	(1.54)
Non-manual			–		–		–		–	
V (10^{-5})	-4.32	(1.72)	-.97	(.61)	2.05	(1.20)	-.09	(.04)	2.20	(1.32)
H_u	.46	(9.86)	.16	(4.30)	.005	(.12)	.10	(1.42)	-.02	(.55)
Age	.09	(3.53)	.12	(3.75)	.02	(1.22)	-.008	(.42)	.10	(7.06)
Age^2 (10^{-2})	-.01	(4.26)	-.02	(4.27)	-.04	(2.57)	-.02	(.89)	-.10	(7.13)
Family size	-.54	(10.2)	-.25	(5.62)	-.009	(2.24)	-.10	(1.79)	.15	(3.68)
No. of actives	1.03	(12.9)	.22	(3.71)	-.10	(1.75)	-.02	(.24)	-.08	(1.43)
No. of pupils/students	.47	(6.64)	.21	(3.77)	.15	(2.94)	.13	(1.74)	-.08	(1.53)
Constant	-3.79	(5.40)	-2.84	(3.93)	-.49	(1.18)	2.43	(4.84)	-2.29	(10.4)
Log-likelihood	-462.30288		-841.04344		-996.66197		-449.46832		-1043.8615	
(t-values in parentheses)										

Table A2

Wage equations

Variable	$\ln W_f$		$\ln W_t$		$\ln W_m$	
Male	.18	(6.13)	.13	(1.43)	.12	(1.27)
Schooling	-.05	(2.17)	.04	(.45)	.04	(.53)
Schooling^2	.005	(4.42)	-.002	(.73)	-.003	(.82)
Experience	.02	(3.92)	.02	(.96)	.02	(.98)
Experience^2 (10^{-4})	-2.88	(3.04)	-3.38	(.82)	-3.20	(.78)
Unskilled	-.28	(4.76)	-.04	(.16)	-.06	(.27)
Semi-skilled	-.11	(2.00)	-.22	(1.14)	-.32	(1.95)
Skilled	-.10	(2.21)	-.30	(1.80)	-.30	(1.92)
Non-manual	.003	(.08)	-.03	(.19)	-.08	(.59)
Other manual	–		–		–	
λ	.02	(.76)	.13	(.77)	1.07	(1.48)
Constant	2.92	(17.96)	3.56	(9.23)	2.70	(4.52)
Adjusted R^2	.23		.02		.18	
F value	32.88		1.05		10.08	
log-likelihood	-758.95		-620.25		-562.79	
(t-values in parentheses)						

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DID WE INDEED CONSUME TOO MUCH?

I. KOVÁCS

The paper investigates the relationship between the shares of personal consumption and social consumption in kind within the GDP and the level of development. In Hungary the share of personal consumption is lower by 15–18 percentage points and that of social consumption in kind higher by 4–5 percentage points than in other countries on the same level of development. The assumption of "overconsumption" is based in IMF and World Bank statistics using Hungarian and OECD data of differing content.

There are prominent economists and politicians in Hungary who have stated quite definitely that the population has consumed more during the past two decades than was really permitted by the country's level of economic development, and the state has run ahead of itself, particularly with regard social expenditure (*Kornai* 1992; *Szapáry* 1993; *Tardos* in Karsai 1993; *Muraközy* 1992). This rhetoric supports the view also proposed by international agencies like the IMF and World Bank: namely, that the budget deficit should be reduced by cutting social expenditure, and people should bear additional burdens in order to stimulate and balance the economy.

Although I think these views are debatable and not well-founded, I am also of the opinion that facts themselves have to tell their own stories to refute and question or justify the thesis mentioned above. This paper is mainly concerned with the following question: how much did we consume as a function of the level of economic development as measured by per capita GDP?

A cross-country analysis covering seventeen OECD countries is applied to show a casual relationship between per capita GDP and the share of consumption in GDP. After analyzing international tendencies of this relationship, and then putting and focusing Hungary's consumption/GDP ratio in an international context, the question addressed in the title and also similar ones can be answered: How does Hungary fit into the international trends? Did we approach, or get even farther from these trends?

Methodology, and clarification of concepts

For a better understanding, first of all let us consider and view the consumption categories that will be used in this paper. *Table 1* shows two approaches

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I would like to express my gratitude to Maria *Augusztinovics* for her valuable and helpful comments.

of the allocation of gross domestic product: 1. according to the System of National Accounts (SNA) applied by international organizations (UN, OECD etc.), and 2. according to national accounts in Hungary.

The Hungarian national accounting system is essentially in accordance with SNA (with the exception of formal differences which are, however, negligible).

The SNA operates with two categories of final consumption in GDP as *1. private final consumption and 2. government final consumption. The government final consumption includes*—beyond general public services, defence, public order and safety—*education and health, social security and welfare, recreational and cultural services* (i.e. factors which influence directly the well-being and standard of living of the populace). In the Hungarian statistical system these services—also financed by the state budget—are handled separately and called *social income in kind*, and are viewed as additions to private consumption by households. Unlike the practice of OECD countries, the Hungarian national accounting system thus differentiates three related consumption categories: namely, *total consumption by households, and its two components—private consumption and social income in kind*. Separate data are available on each of the three consumption categories.

Table 1

Components of the gross domestic product in two versions

SNA	Hungarian version
Government final consumption including health, education, etc.	Public consumption
	Total consumption of population
Private final consumption	Private final consumption
	Social income in kind including health, education, etc.
Gross fixed capital	Gross fixed capital
Total domestic use	Total domestic use
Balance of export-import	Balance of export-import
Gross Domestic Product	Gross Domestic Product

Analyzing countries from the point of view of how great a part of total consumption is provided to families free in the form of public services such as education, health care, culture, etc., and how much can be purchased from their disposable income, we have to be aware of the fact that these proportions are mainly consequences of differences in institutions and traditions among countries. Deep-rooted "social contracts" between populace and government with regard to financing social expenditures greatly determine the shares of private consumption and social income

in kind in gross domestic product and—even in cases when they are unwritten—are not usually broken unilaterally.

Here are some examples of the different ways of financing social expenditure in certain countries: health care in the United Kingdom is basically free, so health share in private consumption is near to zero, while the costs of free health services appear in government final consumption expenditures. In France and the United States private health insurance systems are dominant, but free health benefits are provided to low-income families.

Indeed, we could obtain reliable results from an international comparison if the compared consumption categories had identical content. The disadvantageous practice of the System of National Accounts, by having no direct statistics for social income in kind and total consumption by households, is an obstacle to a more realistic approach of international comparisons. It is true, however, that data could be obtained for total consumption in an indirect way, so that appropriate social expenditures extracted from government final consumption should be added to private consumption. This is, however, not always that simple, because information on the distribution of public services among various categories is rather scanty, not available for each country, and in this case we have to rely upon estimation. Nevertheless, the risk of estimation should be accepted, in order to complete the analysis of private consumption by that of social income in kind. The insufficient data base for OECD countries is the main reason for not having as much deep research on the international comparison of the social relative to the personal consumption (*Cao Pinna and Foulon* 1975; *Saunders* 1980; *Garin-Painter* 1970; *Cao Pinna and Shatalin* 1979; *OECD* 1985).[1]

Up to this point it has been demonstrated that the relevant consumption categories used in this paper are relevant for the study. Now we turn to income categories as the sources of consumption which will be referred to further in the analysis (see *Table 2*).

Two components of total income, in addition to labour income (and capital gains), are called "*social income in money and social income in kind*". Social income in money (cash transfer from the budget), including pension, sick-pay, family allowances, maternity and child-care allowances, stipends, and unemployment compensation becomes a component of personal disposable income, and as such, is assigned to finance private consumption. A total picture of income redistribution of the national economy in Hungary was portrayed by Augusztinovics (1987) in answering the not so easy question of "who pays what" in the society.

[1] It appears that I am knocking on open doors because according to the latest news, there are going to be changes in SNA in the desired direction (*Árvay* 1992). When this will be realized in practice is a question for the future.

Table 2

Income sources of total consumption and its components

Income source	Consumption
Total income of population minus saving	Total consumption of population
Personal disposable income minus saving	Private consumption
Labour income	
Social money income	
Social income in kind (health and medical care, nursery, kindergarten, medicines, education, culture, sport and recreation)	Social consumption in kind (health and medical care, nursery, kindergarten, medicines, education, sport and recreation)

Macroeconomic weight of consumption and the level of economic development

In any national economy consumption is the largest category of aggregate demand, regardless of whether it should be either national income, gross domestic product or gross national product. It follows merely from its quantitative weight that consumption plays a decisive role in economic development and economic stability.

In the long run, as a consequence of economic progress and structural changes, the share of consumption decreases either in gross national product or in total domestic use. The decreasing tendency was more palpable up to the Second World War as *Kuznets* (1962) showed, but it follows up essentially to the eighties in a much slower space, as shown by *Ehrlich* (1970) and *Kovács* (1986). Thereafter, during the past two decades, the decline of the consumption-GDP ratio in the most developed countries seems to have either stopped or to have become extremely slow.

The level of a country's economic development

Focusing on the seventies and the eighties, we can draw a cross country comparison in 1970 and in 1989 to shed light on the relationship between the share of consumption in gross domestic product and the level of development, as indicated by per capita GDP. Data for per capita GDP expressed in international dollars relative to that of the United States are shown in *Table 3*.

Over twenty years, changes in the stages of various countries' level of development are characterized first, with the catching up of the United States, and second by, to a great extent, of the levelling off among the developed European countries. This is well reflected in the fact that, in 1970, the eleven high income European

Table 3

Per capita GDP, in USD (US=100)

	1970	1990		1970	1990
Turkey	19	22	Belgium	65	76
HUNGARY	24	29	Finland	58	77
Greece	30	34	Austria	54	77
Portugal	24	41	Denmark	73	78
Spain	42	55	Sweden	77	79
The Netherlands	69	73	France	68	81
United Kingdom	61	74	Japan	56	82
Italy	55	74	Germany	69	85
Norway	61	75	United States	100	100

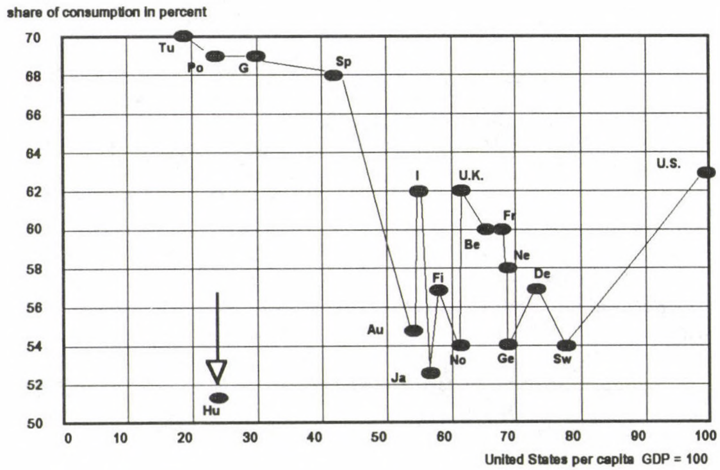
Source: 1970 data: *Summers and Heston* (1991)
1990 data: International Comparison Program
Countries come after each other according to their rank in 1990.

countries and Japan were in the range between 53 and 77 percent, while twenty years later the same countries crowded between 72 and 85 percent; on the one hand the range shifted upward, but on the other it became narrower.

The process of catching up was especially fast in the fifties and the sixties when the growth rate was generally extremely high. This tendency could not be stopped, even by the economic recessions during the two decades (i.e. even after the rapid progress terminated in the early seventies). Some countries avoided this situation and others were afflicted more than others. This conclusion is supported by the remarkable fact that during the time covered, the per capita GDP of the US approached (respectively) 17, 19, 23 and 26 percentage points relative to Portugal, Finland, Austria and Japan. Although the position of Hungary in the range did not change during this period, its per capita GDP got closer to that of the US: i.e. from 24 percent in 1970 to 29 percent in 1990. Relative to Austria, Hungary's position deteriorated 7 percentage points, due to the quick progress in Austria: i.e. while in 1970 the per capita GDP of Hungary was 44 percent of that of Austria, the corresponding figure was only 37 percent in 1990.

Changing tendencies

Table 4 presents figures for the shares of private consumption, social income in kind, and total consumption of households in GDP, and their relation to per capita GDP is shown in *Figures 1–6*.



The source of Figures 1–6 is Tables 3–4.

Fig. 1 Shares of private consumption and per capita GDP, 1970

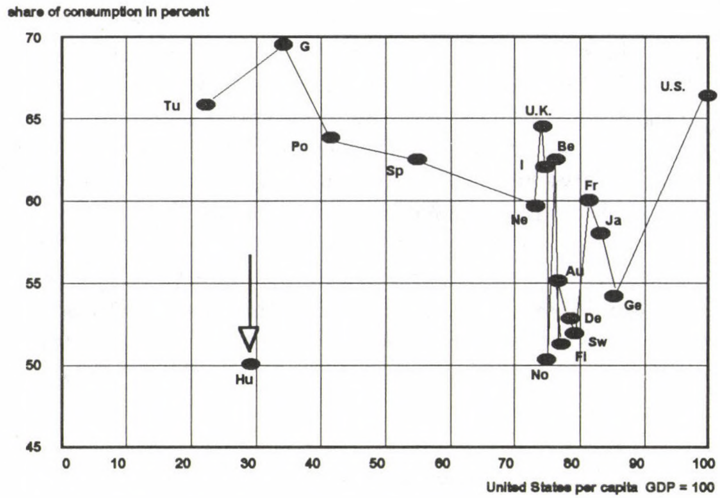


Fig. 2 Shares of private consumption and per capita GDP, 1989

However, it is doubtful that the strict correlation reveals, nevertheless, that it can surely be stated that *shares of private and total consumption are generally higher in low than in high income countries*. This means that these shares are

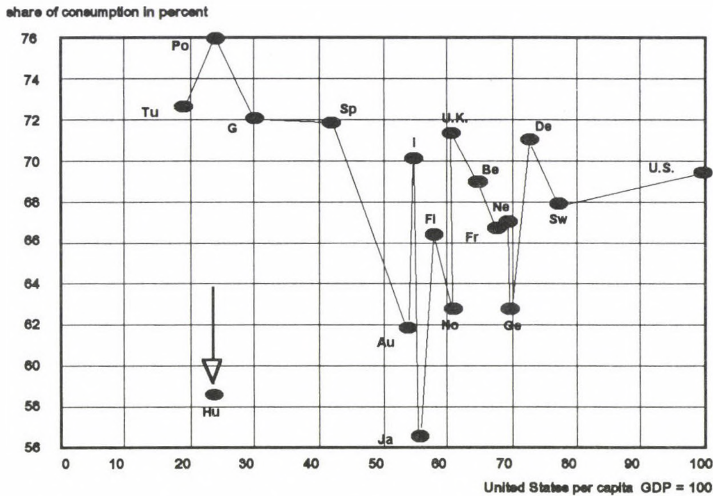


Fig. 3 Shares of total consumption and per capita GDP, 1970

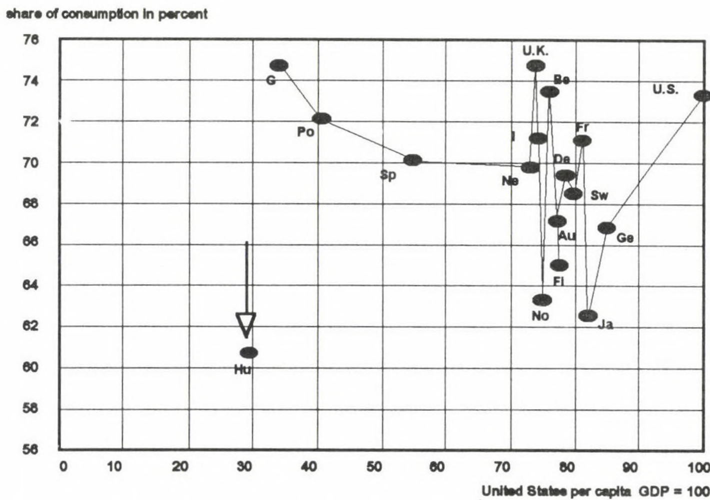


Fig. 4 Shares of total consumption and per capita GDP, 1989

inversely proportional to the level of economic development, while among highly developed countries there is no relationship whatsoever in association with the level of economic development, as can be seen in *Figures 1–4*. By contrast, shares of social consumption in kind are in direct proportion to the level of economic development: *rich countries spend a bigger proportion of their GDP on health,*

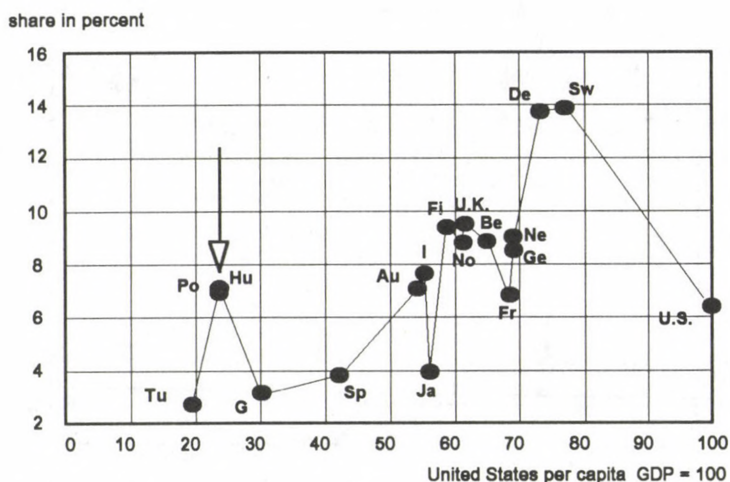


Fig. 5 Shares of social consumption in kind, and per capita GDP, 1970

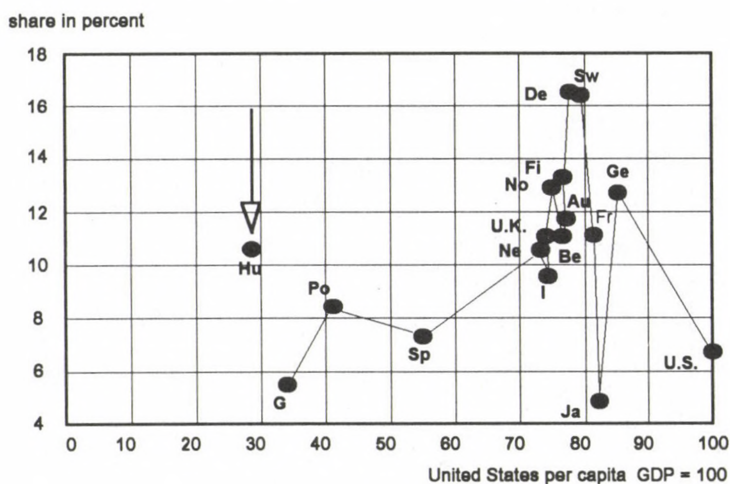


Fig. 6 Shares of social consumption in kind, and per capita GDP, 1989

education, culture, recreation, etc.—as can be seen in *Figures 5–6*. Graphs and correlation coefficients also show that the not too strong relationship in 1970 became even looser for 1989.

It would also be interesting to analyse the question of why shares of private and social consumption in the United States differ so much on a long historical

Table 4

Shares of consumption in GDP in Hungary and in OECD countries

Country	Private consumption		Social consumption in kind		Total consumption	
	1970	1989	1970	1989	1970	1989
Turkey (Tu)	70.0	66.2	2.7	–	72.7	–
HUNGARY (Hu)	51.3	50.0	7.1	10.7	58.4	60.7
Greece (G)	69.0	69.3	3.1	5.4	72.1	74.7
Portugal (Po)	69.0	63.7	7.0	8.4	76.0	72.1
Spain (Sp)	68.0	62.7	3.8	7.4	71.8	70.1
Netherlands (Ne)	58.0	59.3	9.0	10.5	67.0	69.8
U.K. (U.K.)	61.9	63.8	9.5	11.0	71.4	74.8
Italy (I)	62.6	61.7	7.6	9.5	70.2	71.2
Norway (No)	54.0	50.4	8.8	12.9	62.8	63.3
Belgium (Be)	60.0	62.5	8.9	11.0	68.9	73.5
Finland (Fi)	57.0	51.7	9.4	13.3	66.4	65.0
Austria (Au)	54.7	55.5	7.1	11.7	61.8	67.2
Denmark (De)	57.4	52.8	13.8	16.6	71.2	69.4
Sweden (Sw)	54.0	52.2	13.9	16.4	67.9	68.6
France (Fr)	60.0	60.0	6.7	11.1	66.7	71.1
Japan (Ja)	52.5	57.7	3.9	4.9	56.4	62.6
Germany (Ge)	54.2	54.2	8.6	12.7	62.8	66.9
U.S. (U.S.)	63.0	66.7	6.5	6.7	69.5	73.4

Source: Calculations for OECD countries based on *OECD* (1980, 1991), and for Hungary: *KSH* (1975, 1985, 1991). Countries in table succeed each other according to the rank of development in 1990. Country symbols that appear on the graphs are in parenthesis.

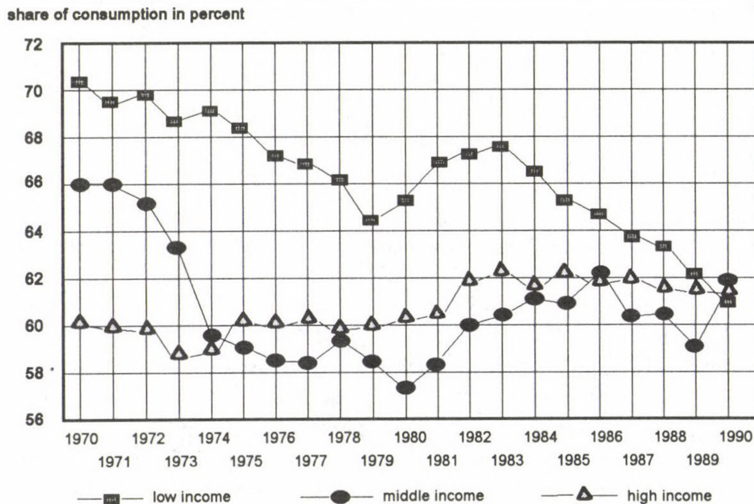
course from those in the highly developed European countries. Put another way, what is the reason for the shares of private consumption being remarkably different in some highly developed European countries of similar level of economic development? However, such analysis is not permitted by the limits of this paper.

Shares of private consumption in 1970 varied between 55 percent (Japan) and 72 percent (Greece), but after a period of nearly twenty years, in 1989, and at a higher stage of development, the range of consumption shares shifted downward a few percentage points between 51 percent (Norway) and 69 percent (Greece). The extreme values decreased in the long run. This was not followed, however, by a simultaneous change, either in the width of range or in the average share of private consumption in OECD countries: this latter was around 60–61 percent both in 1970 and 1989.

Figure 5 suggests for 1970 a relatively palpable relationship between the level of economic development and the shares of social income in kind: *the higher per capita GDP, the higher the share of social income in kind*. This picture, however,

also shows other features, the most conspicuous of which is that the most advanced country, the United States, devotes about the same proportion of its GDP to these expenditures as countries approaching about 50–55 percent of its level of development. The other remarkable exception is Japan because, relative to its level of economic development, the share of social income in kind in GDP is extremely low: i.e. under 4 percent.

By 1989, the relationship became very loose and the exceptions of the U.S. and Japan are even more detectable. When explaining the reason for these exceptions it cannot be left out of consideration that beyond the visible extension of the welfare state there are certain forms of welfare activities that do not appear directly in statistics like tax reliefs and allowances, or some benefits provided by employees (*Szamuely* 1985). Szamuely states: "... it is known, that especially this latter form has widely spread in the sphere of big enterprises in Japan and in the United States. This is an alternative of 'the nationalized' welfare policy, but it exists with the assistance of the state, and considering its essence, it covers a redistribution realized by the tax policy of the state" (Szamuely 1985, p. 123.).



Source: *World tables* (1992)
"Low-income economies are those with a GNP per capita of $610 or less in 1990. Middle-income economies are those with a GNP per capita of more than $610 but less than $7.620 in 1990. High-income economies are those with a GNP per capita of 7.620 or more in 1990." (World tables 1992, p. VIII)

Fig. 7 Share of private consumption in low-, middle- and high-income countries

The picture would be misleading if only high-income economies were taken into consideration when drawing conclusions about regularities for consumption

shares. *Figure 7*, based on the time series of World Tables, shows the average shares of consumption in GDP plotted against time for high-, middle- and low-income countries. In 1970, at the beginning of the time period investigated, a weak regularity is revealed, and we can arrive at the conclusion that shares of consumption are lower in high-income than in middle- and low-income countries. Afterwards, we face, however, a very peculiar picture in *Figure 7*: *the average share of consumption in low-income countries gradually decreased* over the two decades—with the exception of an increase in 1979–1983—and by 1990 it fell short of that of the two other country groups.

Although it is concerned with averages, the graph is significant because it supports the previously shown trend of advanced countries: the distinct association between shares of consumption and the level of economic development, which was said to be rather strong in the fifties and the sixties, seems to become loose by the end of the eighties. With regard to predictions about the future, it would, however, be very difficult and also unreliable to use these results.

Hungary's standing by international comparison

When evaluating Hungary's share of consumption in GDP, we have to start from the previously generalized relationship that private and total consumption of the population accounts for a bigger proportion of GDP in lower than in high-income countries, while the opposite association holds for social income in kind: high income countries spend a bigger proportion of their GDP on social income in kind than low- and middle-income countries.

The fact that Hungary is a relatively less developed or rather middle-income country, means that there should be a relatively high share of private consumption and relatively low share of social income in kind adequate to the country's level of economic development.

Even without any kind of analysis it is astonishing (by any economic standard it is striking) that Hungary's statistics show interesting figures regarding the share of private or total consumption in GDP—see *Figures 1–4*. It can be seen that shares not only conspicuously differed from those of countries in similar economic situations (like Greece and Portugal either in 1970 or 1989), but were the lowest among countries considered in the investigation: the share of private consumption is 51.3 percent and 50.0 percent for 1970 and 1989 respectively, while figures for total consumption are 58.4 percent and 60.7 percent.

In 1970 the share of private consumption in Hungary exceeded that of Portugal and Greece by 18–20 percentage points. This is a strikingly big difference: 11–15 percentage points according to that of middle-income countries and 8–9 points according to the average share of OECD countries (see *Figure 8*).

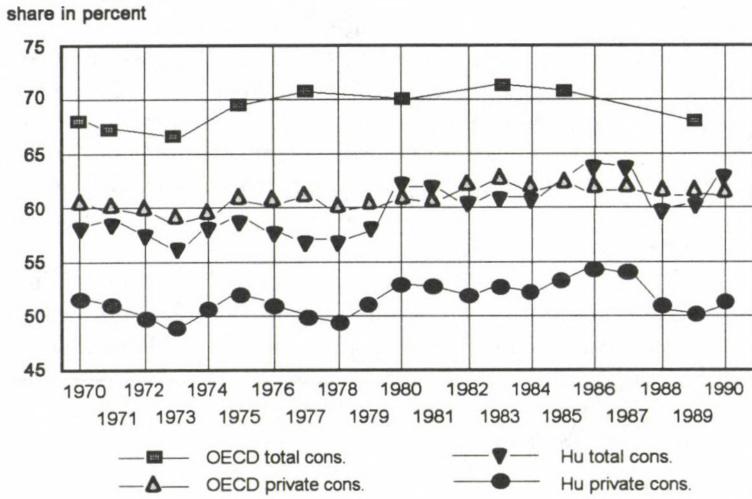


Fig. 8 Shares of private and total consumption in Hungary and in the OECD countries, 1970–1990

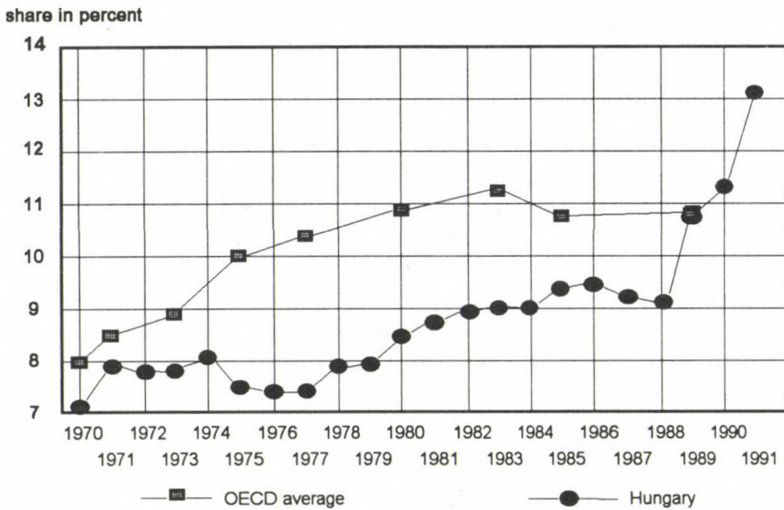


Fig. 9 Shares of social consumption in kind in Hungary and in the OECD countries, 1970–1990

Regarding the root of the matter, the picture did not change in 1989; in fact, only the deviation decreased to a small degree: Hungary's distance from countries at a similar level of economic development is 13–15 percentage points, while it is 9

and 6–7 percentage points from middle income countries and from the average of OECD countries respectively.

Turning now to Hungary's share of social income in kind in GDP, it was 7 percent in 1970. This was somewhat higher than in Portugal, Greece, Spain, Japan, and the United States, but one percentage point lower than the average share of OECD countries, as can be seen in *Figure 9*.

In 1989, in addition to the listed countries for 1970, Austria also had a lower share of social income in kind than Hungary. By that time, however, the Hungarian share approached 11 percent; this was equal to the OECD average. *Regarding social income in kind (both in 1970 and in 1989) Hungary was ahead of countries at similar levels of economic development by about 4–5 percentage points. In other words, it did not lag behind so much as it did with regard to private consumption.*

When the two shares are added to form the total consumption of households, we can conclude that Hungary's position in international comparison has not changed in 1970 nor has it changed in 1989: social income in kind did not compensate the extremely low share of private consumption, and thus Hungary deviates from the general pattern with regard to the private or total consumption of households.

It might, however, be even more astonishing when time series of shares of private and total consumption in Hungary and in OECD countries are compared between 1970 and 1990, as can be seen in *Figure 8*.

It not only happened that *the share of total consumption of Hungary fell short of that of the OECD average of 10 percentage points, but it also lagged behind even the average share of private consumption in OECD countries, apart from five exceptional years in the eighties*!

Having a steady 50 percent share of private and about 60 percent share of total consumption in GDP during the past two decades, it would be hard to say that there was an "excess consumption" in Hungary. Thus what is the explanation for the underlying views and opinions which emphasize "excess consumption" in Hungary?

Data and the refutation of the assumption of "excess consumption"

There is no doubt that the weight of social income in GDP—referred to previously as social income in kind together with social income in cash (transfers from the government)—increased significantly in the (earlier) period under consideration. This fact, which is considered among others to be a manifestation of the overwhelming role of the state, was followed by a faulty income distribution policy and it has received considerable and frequent criticism. Many argue that in an international comparison Hungary has spent too much on social expenditure: i.e.

much more than was appropriate for its level of economic development; Kornai says: "The Hungarian welfare state was born "prematurely". He goes on to argue: "There is generally a close positive correlation between a country's level of economic development and the scale of its welfare services. Development is not the only factor, but it is among the decisive ones. Hungary was 'ahead of itself' in this respect" (Kornai 1992). A similar way of thinking and arguing also appears in the paper of Muraközy (1992). Tardos (see Karsai 1993) speaks not merely about the exaggerated weight of welfare expenditure and the populace's unchanged expectations with regard to these services, but also about the decrease of "over-consumption" which should be realized after the election in 1994. As he expressed in a lecture, Szapáry, a former representative of the IMF in Hungary, is of the opinion that the huge budget deficit could be cured in Hungary by trimming the social expenditure from the budget that is delivered to households.

I share the opinion about the exaggerated role of the state in the socialist system; however, this has retained its overwhelming position during the transition. I also share the opinion that income and social policy did not work correctly, and the consequences of this can even be felt now, and this is in spite of the fact that plenty of people were its beneficiaries. However, I disagree with the opinion of those who find the weight of social expenditure in Hungary too high in an international context. Secondly, I also disagree with those who try to evaluate the role and weight of social expenditure without considering the evidence about private consumption. Whenever the share of social expenditure is declared high by many, not much is said about the share of private consumption. I think this is the main clue when analyzing Hungary's social expenditure in an international context: neither the share of private consumption nor the share of social expenditure can be investigated in itself.

My reasoning is as follows: the relationship cited by Kornai between the level of economic development and the share of social expenditure in GDP cannot be considered close (although it holds that each prominent and classic welfare state belongs to the cluster of highly developed countries: a high share of their GDP is devoted to social expenditure). However, the inverse does not hold: not every rich country devotes as high a share of GDP as welfare states to social expenditure—see for example the USA, Japan, France and Germany.

The data cited by Kornai from *Kessides et al* (1991) compiled by the IMF show that in the period 1980–86 the share of social income in GDP in Hungary was 5–7 percentage points higher than in countries of similar economic development. However, it also showed that, significantly, it was 8–10 percentage points lower than in highly developed welfare states. Yet it is necessary to look behind statistics!

When comparing the social incomes of Hungary and the OECD countries it is clear that the World Bank and IMF circulate inaccurate, misleading information; consequently, this inspires conclusions that are based upon the "facts" provided.

In *World tables* and in *Trends in developing economies* there were data that proved to be most astonishing. In the Table "Private consumption: percentage of gross domestic product", with reference to Hungary *the share of total consumption of households* can be seen (this is very likely in the case of Czechoslovakia too), while private consumption is presented for all the other countries (World tables, 1992. p. 60; Trends in developing economies, 1992. p. 259). The unsuspecting economist, analyzing economic data sources compiled in the System of National Accounts, should not even dream of questioning precisely the verity of Hungary's data.

However, staying with the topic of social incomes, in the publications mentioned above two important circumstances have not been taken into consideration. One of them is that, out of the two components of social income, the social income in money includes pensions as a social security expenditure taken explicitly from the budget. In the OECD countries, pensions from the budget are social benefits; yet in addition to pensions from the budget, other types of pensions from different private funds account for a great deal of the total pension expenditure. In contrast, all pensions in Hungary come from the state budget (in this respect the fact does not have significance, because the social security fund has just recently been separated from the state budget). However, it is a well-known fact that the great bulk of the pension is not a free benefit. As a consequence of faulty economic policy, according to which pension contributions paid by employees and employers have been included in the budget and have been mixed up with other revenues, for decades the socialist state was able to keep up the appearance that pensions are a social benefit.

Thus, a direct comparison in this respect between Hungary and the OECD is not reliable, because Hungary is shown to be in a better shape than the reality. The higher the share of pensions in social income in money, the more biased the picture. Between 1970 and 1990 the share of pensions in social income in money increased to 62 percent from 55 percent. Therefore, the only comparison that would be justified between Hungary and the OECD would be concerned with the identical content of categories.

While it can be shown that the total volume of pensions at a macro-level increased significantly (Muraközy 1992), paradoxically, individual pensions in real terms decreased because of the lack of indexation in line with the high inflation rate (*Hoch and Kovács* 1984).

The paradox phenomenon between real-income at a macro, and individual level is perceived all the more due to the higher the rate of inflation, and the faster the ageing of society.

The other fact, which has been neglected, judging Hungary's social income in an international context, is that social income in kind is compared separately and independently from private consumption. I think that the unequalled low weight of private consumption in GDP should question the allegedly "high" weight of

social income in kind. When, in terms of GDP, the U. S. spends less than half as developed welfare states on social expenditure in kind, we have to bear in mind that the U.S. has an outstandingly high share of private consumption in GDP, and with the sum of the two shares forming total consumption, America belongs to the country group—Sweden, Denmark, France, United Kingdom, and Italy—whose share of total consumption is high.

Regrettably, it is also about keeping up a politically important appearance that a relatively developed social policy has characterized the past decades. The country faced a purposely distorted macroeconomic structure sanctified by a long existing "social contract" between state and population: namely, that an extremely low share of private consumption will be paired by a relatively high share of free benefits. A lesson from international comparison, however, does not show that a low share of private consumption was accompanied by a strikingly high share of social income in kind; yet it does show that the latter share was merely 4–5 percentage points higher; the former, however, was 18–20 percentage points lower than in countries at similar stage of development.

The system was planned in such a way that wages and personal disposable income never included costs of non-market services; the state drew away what workers produced, and it redistributed a part of it through its entangled, inscrutable channels. Augusztinovics (1987) has also shown that "total consumption of households should be considered as the reproduction cost of labour. This is how much labour, producing new value costs at the macro-level. Therefore, that part of total consumption, that is financed by the government budget, is actually labour cost". (Augusztinovics 1987, p. 514)

As Hungarian consumers were still to buy such services which were not covered by disposable income—as it is a well known fact health care and education declared free have never been free—then they had to modify their budget shares: less durable, less food, less clothing, etc.

As far as the government decides about these proportions, the expected services from the state might be the subject of manipulations that can always be cut. Today, because of economic crisis, nobody can raise the question that—according to the spirit of the silent social contract—what has been cut down on social income in kind, should be given back in the form of private consumption, and more precisely in personal income. When services like health care, education, and culture become market goods, it would then be obvious, by any economic standard, if labour incomes were to cover their costs. This would be the way that the deteriorated structure be adjusted in order to approach the international trend.

In advanced OECD countries, the share of services is high and increasing in private consumption expenditures because discretional income in personal disposable income is also high and permits this. Social income in kind is provided to the needy: thus, there are social purposes indeed. By contrast, in Hungary the share of services in private consumption expenditures is extremely low: 11–13 percent. So-

cial income in kind could not function as a means of social policy because a role to compensate personal consumption was, to a certain degree, assigned to it. This is proved by the fact that social incomes were redistributed not to the needy according to the principle of equity, but independently from the social income to everybody. Therefore this policy, in contrast to its declared goal, according to which social incomes in kind would level differences in labour income, resulted in completely contrasting consequences: i.e. a further differentiation in incomes (Hoch, Kovács and Ördög 1982).

The harmful aftermath of this macro-structure is especially relevant considering present circumstances when, because of its huge deficit, the state budget cannot cope any longer with the ever growing burden of social expenditure (which has been loaded with a great volume of unemployment compensation since 1989). Despite densely differentiated incomes, the former principles of redistribution are still further maintained.

Regarding the root of the matter, I think the so-called Hungarian "welfare" state was not as welfare as it looked on the surface; the higher share of social income in GDP in comparison to the level of economic development is a deceptive, illusory picture.

Epilogue

Although I am crossing the limit of cross country analysis, I cannot avoid speaking about the fact that, since 1989, the share of both private consumption, and social income in kind in GDP has sharply increased. The country faces a grave transformation and structural crisis of the economy, and an increasing consumption share is a necessary follow-up of this crisis. This is because consumption, regarding its inelastic nature, cannot decrease at such a rate as investment and GDP: consequently, its share should increase. To put the assumption of "excess consumption" on this basis, however, means ignoring economic laws. The abrupt development in the share of social income in kind is not due to a real increase in expenditure, but rather to a smaller decline in the real value of social income in GDP between 1989 and 1991. *The increase of shares in private consumption and social income in kind is a necessary consequence of a crisis which can be resolved only in a prospering economy.*

This proposal is in accordance with the theorem of economics: i.e. that in an economic depression the share of consumption has to increase, and in an upswing it has to decrease.

Therefore, the government should have a clear responsibility to fight depression and to enhance the upswing, to call conditions into being for that purpose and to make incentives for, and to carry out effective investments.

I do not think that policy-makers and international advisers are right to rack their brains over what kind of measurements they should propose to the respective governments to restrict consumption. This is because this serves not the goal they want (namely, to get out of the crisis), but rather the contrary effect, to get even more deeply involved.

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OLD HUNGARIAN PRINTS OR DOES THE 200 YEAR CYCLE EXIST?

A. BRÓDY

F. *Jánossy* developed a short-cut method for measuring economic growth without the help of prices. His method allowed the assessment of Hungarian growth and its comparison with that of the developed countries at a time when the official Hungarian price system could not be trusted.

Here I try to apply the same method to analyse a time-series, incomplete for the time being, but theoretically available and well documented for a considerable historical period of time: the number of books published (and purchased by libraries).

To have a clear-cut question to investigate, I propose to look into the existence of 200 year cycles in Europe over the last 600 years.

Introduction

This is an interdisciplinary investigation and therefore, in all probability, it is fraught with unusually large errors and omissions. Some of them surfaced with the publication of the first, Hungarian, report on the ongoing research. However, the oversight could be remedied without any loss to the argument, yet it made me aware of the vulnerability of the whole project. This is rather an essay with a new viewpoint that will take several years to ripen, if it can, into something more solid. Thus I will be very grateful for any—however harsh—critique, for I accept the possibility that there is room for improvement on presentation and also on the theory (if the theory itself remains supportable at all!).

To start from common and universally accepted ground: persistent economic fluctuation in all known countries is an undeniable fact. There are economists who discern more or less regularly returning shapes in these fluctuations and speak therefore about the existence of cycles and look for deeper explanation. I am one of them. Of course the economic motion does not and cannot exhibit any pendulum of regularity. The "mechanism" of any economy is always very loosely jointed and seldom has physical or machine-like couplings. Nevertheless, there do exist certain, however imprecisely given, *proportions* among the various activities that have to be observed and obeyed. For instance, if somebody decides to build a library of, say, ten thousand books, then—in any given historical period—the cost and the time required to build and open such a library will be given, at least within an order of magnitude. Neither will be fixed and immutable: cost and time requirements do change historically (in the 15th century it surely took much more time and money to

start a library and there were no or very few libraries of the size mentioned above). Even at an exactly fixed point of time these magnitudes cannot be observed and measured as precisely as the length and periodicity of a mathematical pendulum. Still these bindings do exist and if they do they may generate cyclical behaviour.

The controversy of cycle-believers and cycle-deniers is presently unresolved and not easy to adjudicate because of the dearth of reliable statistical material. Thus even the existence of cycles of short duration (3 to 5 years, the so-called "inventory" or "Juglar cycles") have not gained universal acceptance. Considering the cycles of longer spans, even the cycle-believers nurse some doubts. The longer the cycles are that we are searching for, the greater is the need for numerical material, yet the less data there is to actually prove their existence; thus we are slowly drawn into the thickening fog of unreliable, sporadic or missing data.

The longer the time span, the less sure we can be. It is the *repetition* we have to prove or, at least, demonstrate with a certain probability. In an econometric sense, to verify the Kondratiev cycle (with its roughly fifty years of duration) at least ten cycles would have to be exhibited. Thus five hundred years of fairly comparable data for economic growth would be necessary. Reliable time series on GDP, on the other hand, are seldom longer than sixty-seventy years, because their systematic collection started only in the 1920s of this century.

I started to accept the existence of the Kondratiev cycle only when I became aware of the cycles of identical duration, frozen into the age-distributions of the human population and disclosed, in few countries, by fresh research. The corresponding theory of the so called "Easterlin cycles"—explaining the swings as an ongoing generational fertility adjustment leading to a two-generation period—also increased my trust. This incidentally raised the hope that, by inspecting various sorts of inventories and scrutinizing them for age distributions, we would be able to increase our knowledge about past cycles.

The 200 year cycle, and its corroboration or negation, is thus a particularly delicate problem because even the demographic data become more and more inadequate as we wander backwards through the centuries. Notwithstanding all this, historians have already divided the European past into roughly 200 year periods and have even given widely accepted names to them. Historians speak about a scholastical period in the 13–14th century, about renaissance during the 15–16th century, about the enlightenment in the 17–18th century and about the "civic" or "bourgeois" or "capitalist" or "entrepreneurial" society for the last 200 years. This may be the invention of historians and does not necessarily indicate cycles. After all, the raw-material of history has to be cut up somehow into smaller parts to prepare it for the toil of the historian who is unable to work simultaneously on all the bits and parts of history.

Stepping stones

Are there clear dividing lines between the historical stages mentioned above? Historians with a broader grasp, for instance *Kennedy* (1989), speak meticulously about the development of *military technology*; that is, about powder and guns, castles and fortifications, boats and gunships, mercenary and regular armies, musket and petronel, rifle and sword, cavalry and infantry, logistics, strategy and tactics, in short: about wars and their ever increasing costs. However, all this only affects the fibre, pull and sway of the constantly changing power blocks. Perhaps it redraws the boundaries of, or reallocates but does not create, all that people consider essential for wealth and possessions. It could be that these boundaries are very quickly absorbed.

Others, for instance *Braudel* (1985), describe thoroughly the agricultural produce, the change of productivity in grain, fruit, and animal husbandry. They investigate the orchards and herbal gardens of the cloisters, ley-farming and three-course rotation, the new plants stemming from the new colonies: potato, corn, tobacco etc. The development here is also convincing, and they also speak about the creation of actual economic surplus. The question still remains, what *purpose* does this surplus serve, how can one *use* it at the level of knowledge strictly given in any epoch? It may serve the courts, cloisters, or the strongholds; one can spend it on arms, guns, ships, crusades and religious missions, battles and religious wars and also on certain other activities—thus furthering education and knowledge.

Only the analysis of knowledge itself, the way new information is established, secured, amassed, ordered and retrieved, how it spreads and is disseminated—in short, the *information technologies* of the given cultural epoch—will convince us that these four periods, following each other, are truly and clearly separable.

There is a clear demarcation line between the scholastical period and the renaissance: parchment and the transcribing monks are replaced by paper, typesetting and printing. This is a genuine breakthrough in technology that vastly reduced the cost of information. While the monk took considerable time at copying (even when a dozen of them were involved in joint dictation) a judiciously proportioned small team of composers and printers could easily dwarf the output of the greatest monasteries. The reduction of costs was thus of huge significance. From then onward it was not only the religious and wordly rulers that could afford a library, but also the wealthier burghers.

Indeed the cheapening was so incisive that the inventor, Gutenberg, hardly considered himself to be a benefactor of mankind, but rather a "pusher" of counterfeit bibles. It was only the coiners, and later forgers of fake paper money, who concealed their activities with that care and secrecy Gutenberg exhibited in hiding the pleasing, but for him almost shameful fact, that he was able to turn out holy texts and books at a seemingly modest cost but in great volume.

Letter-cutting and printing

Indeed the change was so profound that its diffusion took several decades and, together with the discovery of America, historians pinpoint it as the turnstile to modern times, which it probably was. Modern times signify for us the evolution of private opinion and private property. Both rest firmly on *information* and the methods used for taking down and presenting it. Both are almost identical with information itself and their evolution and presence, their *essence* depends very deeply on the state of "information technology".

Besides the printing of books one has to refer also to a perhaps less famous but by no means less important innovation: book-keeping, or accounting. This consists in the methodical registration of business transactions made necessary by credit operations, bills and drafts. Only this enabled businessmen to shift greater sums of money in an age of high business risk and low public security. Information and wealth developed as twin brothers and a merchant of Prato proudly inscribed his credo or motto on the top of his ledger: "For God and Profits".

We have to recall also an innovation embarked upon in the mists of the past: the appearance of the record, letters and numerals, the taking down of correct or false knowledge, and its "catching and fastening". Without records it is hardly possible to grasp qualities and quantities of the world and to compare and analyse them. To find out whether our notions are right or wrong, whether we are thriving or degrading we have to take down the facts, the data. Any scrutiny, probing, examination and study starts and ends with records.

The first records appeared three to four thousand years B.C. The scribe generally recorded inventories, and his main task was therefore an economic one; only occasionally was it historical, when taking down events, names, and dates. It takes a long way from runes and hieroglyphes to texts that already explain themselves to the reader.

Runic marks or Cretan clay tablets (*Chadwick* 1958) usually referred to deliveries or obligations with regard to certain quantities of cattle, corn, figs, oil, etc. They seldom mentioned the person to whom these things belonged, and omitted most of the circumstances because the context was already set unequivocally in the mind of the scribe. At the beginning, the latter was the only person, who could be summoned to interpret whatever he jotted down in the first place. The possibility and necessity to record *texts* that could or may be read and interpreted by other persons was developing but slowly. Few people understood at all what was taken down in the record, so its content had significance only to a handful of the initiated. Thus the alphabet took a long time to be consolidated and thus become written in an unambiguous way. At that time there were always competing and substitute character-signs, variants, mutants, deviations and local quirks.

The "humanist antiqua" now commonly accepted in Europe and greater parts of the world developed only later, around the end of the scholastic period and

it became unalterable only with the advance of type-cutting. It is perhaps this "hardware-coding" of the 40–50 now commonly used alphameric characters that is the most important issue here. This is the main merit of Gutenberg (though he developed another, German, "fraktur" type for his Bible). Nevertheless, he still decided to cut close to 300 different casts to imitate all the ligatures and abbreviations used in the great monasteries of his time.

Thus perhaps it is not printing but rather type-cutting that has to be considered the focal point of Gutenberg's invention. Indeed very fine prints were already available before his time, printed from blocks (*Fitz* 1940). It is therefore the *reusable* type that may have been the main cheapening factor. Anyhow, one should not separate the problem of type-characters and fonts from the whole invention just because the former has relapsed into being one of the weakest points in present-day transnational networking and international software dissemination.

To appraise the jump in technology caused by the innovation, a ten-to-hundredfold increase in the speed of handling information comes to our mind though it is difficult to measure this with any accuracy. Nowadays, with the computer we easily refer to mips and baud rates: as the territory develops, its measurement also becomes more scientific. Anyhow the cheapening was so pervasive that it abrogated the monopoly held by the clergy over text and information. Indeed, when the renaissance epoch turned into the battles of the reformation and counter-reformation, Europe was inundated with books, pamphlets and polemical essays that were able to evade the strictures of papal censorship.

Historians consider the promulgation of the enlightenment as the result of protestant ideas and the growing might of the burghers; in this they are probably right. Yet what else could have helped more the dissemination of ideas and the strengthening of the middle class than the printing, reading and keeping of books? If we attribute everything to the burgher and his new ideas then we neglect the new and basic invention without which the burgher could not have gained a foothold. With a certain malice we may claim that the burgher was an object *of information*, being used for the propagation and proliferation of the latter. All that remains from the old burgher is now but dust and ashes, while information itself has proved to be lasting and we are still building newer and newer structures upon it.

To the detriment of the cycle theory there is no conspicuous development of information technology around the turn of the 16th century. Some new fonts were cut and some new manufactures and printing offices erected; also some new libraries and universities were opened. However, it was at the end of the 18th century that new printing machines, paper-mills, type-cutting and type-setting machines were invented, during the heady times of industrial revolution. It is upon this foundation that our present economic system still rests.

The cluster of technological innovation then subsided, only to be enlivened again by our very own period: the advent of reading, speaking, writing and music-making computers, local and international networks, copying machines, computer-

aided-design and desk-top-publishing—in short all the gadgets of a revolutionary new information technology—have opened up to mankind toward the still unknown new possibilities of the 21st century.

Notwithstanding the lack of impressive technological change between renaissance and enlightenment, we may vindicate the periodization of the historian. There is an essential difference in those four epochs in the availability of information, and thus in the circle of the initiated. While in the scholastical period only a few thousandths of the population were able to gain access, during the renaissance already a couple of percent were drawn into the circle of knowledge and information. This circle was further broadened by an approximately tenfold magnitude in the era of enlightenment. Thus intelligence, at least in theory, finally became open to all. Pandora's box is now ajar and will become practically accessible—even compulsory—for all in the 21st century.

Cycles?

Accepting the existence of the four stages, we may still consider them not as cycles but only as recurring attempts, repeated struggles for a take-off towards our present system. This take-off, then, must have been blocked three times: first by the plague and other pandemics in the 14th century, second by the endless wars and state bankruptcies in the 16th century, and finally by civil unrest and disobedience in the 18th century. According to this view the final and real take-off succeeded only in the 19th century; consequently, we can speak about economic cycles, if at all, only after the Napoleonic wars.

Still, there are quite a few economic historians who strongly believe in the existence of cycles and usually connect them to the hegemonic shifts observed. For instance, A. G. *Frank* and B. K. *Gills* (1993), taking up the history of the worldwide economic system and explaining the shift that brought Europe to the centre by 1492, express their arguments in the well-known terms of cycle theory. The perplexing problem with such writers is that they consider cyclic motion as the normal way of life (which it well may be). Nevertheless, it would necessitate explanation, proof and theory. Yet historians seldom fix the exact turning points of their cycles and rarely give numerical documentation of their existence. Moreover, they almost never come up with any theory as to how and why a cycle is born. It is therefore inadmissible to quote crude declarations as corroborating evidence. We have to work it out in our own way.

An initial theory, leading to the first clue about 200 year cycles, came with a rudimentary cycle theory, as developed to some length in Bródy (1985). It may be summed up in the following way:

There do exist two important economic variables: the theoretical rate of growth, say r, and its actual rate, s. They are both, to our deepest chagrin, unobservable and if we compute and approximate them from statistics they carry sizable tolerances with them. Still their persistent difference (and they are never strictly equal) can be noticed quite well if cumulated (integrated). If, namely, the actual growth rate surpasses the theoretical one, then the inventories must decrease just as effectively as they increase in the opposite case.

The economic system tries to correct this discrepancy. This does not work always through a market-mechanism. Even the simplest eco-system must possess some correcting mechanism to survive and every system of regulation will have its own cycles. The eco-systems are therefore also prone to cyclical fluctuations. The mathematical equation of such a self-steering and growth-correcting mechanism may be, in first approximation:

$$\int (r-s)dt = D \cdot ds/dt \tag{1}$$

That is: the perceived increase (decrease) in availabilities (stocks or inventories) is corrected by stepping up (down) the growth rate. This may be an entirely uncalculated, even unconscious correction, like the proliferation of predators in the presence of abundant prey. (D will then be a general factor of proportionality). Such a system will have the solution:

$$s_t = r + \sin(t \cdot D^{-.5}) \tag{2}$$

This yields an exponential growth, with the theoretical growth rate as the trend, and to which an oscillating motion will be added. The amplitude and phase of the oscillation is neglected here. It depends on the initial conditions.

If we are in an economic system and correct the growth rate by investments, as is usual in market and planned economies alike, then the value of D will be governed by the gestation period, g, and the life span of investment, or capital/output ratio, b:

$$D = b \cdot g \tag{3}$$

Thus if the available surplus stocks are used to further growth then the amount of additional growth secured by this surplus will depend on the capital intensity of production (b) and the time during which the additional investment is tied up in the process of gestation (g). Hence the length of the cycles so generated must be:

$$T = 2 \cdot \pi \cdot (b \cdot g)^{-.5} \tag{4}$$

The Kondratiev-cycle may therefore be derived from the well-known 9 months of pregnancy (the gestation period), and some 70 years expected life span, as

$2 \cdot \pi \cdot (52.5)^{-.5} \approx 46$ years. Yet if we consider, instead of pregnancy, the educational gestation period, the latter will be much longer and will cover roughly 20 years. This of course, means that the human being is taken not as an animal and not as a physical entity, but as a cognitive entity. Multiplied with the remaining 50 years life span we arrive at a $2 \cdot \pi \cdot (1000)^{-.5} \approx 199$ year cycle time. This made me first aware of the theoretical possibility of such a cycle.

There is also a second, not contradictory, deduction of a comparable cycle length. *Arnold* (1980) in his genial book on the mathematical methods of mechanics demonstrates very early in his discussion (chapter 2, paragraph 4, point D, first and second exercise) that the time period of small oscillations around equilibrium, that is the minimum point of the potential function r, say, r_0, must be:

$$T = 2 \cdot \pi / (d^2 r / dt^2 (r_0))^{-.5} \tag{5}$$

Checking the potential function, introduced by von Neumann in his famous model of equilibrium growth, we note that the secular rate of growth (which can be found at a point of minimal energy if we transcribe his model into a Hamiltonian form) is around 3 percent per annum, according all the long-run statistics we have. In this growth rate, being the logarithmic derivative of an exponential function, the second derivative equals 0.0009 and its square root 0.03. This then yields $T = 2 \cdot \pi / 0.03 \approx 214$ years—i.e. surprisingly close to the former estimate.

The fact that a mathematical theory for such a cycle can be built in such an apparently convincing manner should not lead us to the supposition that such a cycle truly exist. We have only rendered a very weak theoretical verification that it *may* exist. Even if it exists, a seemingly small but devastating question remains to be answered. *What* is it that may behave here cyclically? We may hardly speak about GDP or national income in the cases of societies for which such categories are ill-defined and unquestionably never measured. Even Jánossy's short-cut method, with its broader definition of growth (Bródy 1992) ceases to be serviceable. We do not have any assortment of indicators of production and consumption measured in natural units.

Some sporadic price statistics are extant from early times onward but they render scant help. Though Jánossy's method allows the derivation of price proportions as well as their change along a typical growth path, the reverse is, alas, not true. As thermodynamic theory teaches us: we may compute all the intensives from the extensives but the opposite is usually not possible. We are unable to deduce from the dual (intensive) proportions of prices those absolute values of the primal (extensive) magnitudes that gave rise to the former.

Thus, for the time being I propose to undertake another, slightly different path.

The "amount" of knowledge

We have to phrase our thoughts about the cycles of communication, intelligence or knowledge in more tangible terms. Let us think about a library where the first measure that comes to mind is the number of volumes. This imaginary library may undergo a long cycle of acquisitioning. I would not claim that the cycles of intelligence and learning should be derived from the fluctuation of library holdings but, on the other hand, the ebbs and high tides of intellectual life may be *reflected* in the number of books acquisitioned during the successive years.

Our imaginary library perpetually grows, let us say, by 1 to 5 percent per year. One may ask whether such a growth would be smooth. Probably not, yet why should it be cyclic? It may simply fluctuate because the economic circumstances change and the money spent on new books does not flow evenly.

Yet we may still assume that in years of economic upswing there will be more money to purchase books. In difficult times fewer or indeed no new volumes are added to the inventory, and it may even decay. (The very famous Hungarian royal library of the renaissance king Matthias had been almost totally dispersed by the end of the 16th century. However, some of its codices and other fragments were then discovered two centuries later in the Austrian state library.)

We may also assume that an experienced librarian would try to *regulate* the influx of new books with his ordering system in order to keep track of the new publications and offers and, generally speaking, to keep up with the movements of the book trade (his resources permitting).

Therefore, data permitting, we may construct two separate kinds of time series: the number of books purchased in the given year and the number of books present and carrying a certain year as their date of publication. It is the latter time series that can be more easily reconstructed, but the difference of the two series, if it can be ascertained, also holds interesting information about the original process. With the advent of up-to-date computerized inventories (and search) one can hope for easy access to the time-profile of the holdings of the great libraries of Europe.

In Hungary we seriously lag behind in the computerization of our libraries and no complete listings are yet available. Nevertheless, we do have bits and shreds of information even for earlier periods. Indeed, there were already library lists even for the first few monasteries around 1000 A.D., but there is only scant information about (and no enumeration of) the demographic composition of the population for the same period, and there is certainly no report on their production and consumption activities. Yet it was the learned brains of the country who handled the few, precious books and the librarian who always had to be one of the most educated persons around. In general, libraries were supervised with more care and know-how than any other aspect of life, and cultural life in particular.

There is now a range of books that are exhibited everywhere with great care and pride: e.g. the first printed books published between 1455 (the year in

which Gutenberg's 42 line Bible was published) and 1500. These are the so-called *incunabula* or "craddle-prints".

The registration of these rare gems has its own story with its own inside periodicity of, yes, also, 200 years. The interest in the first prints awakens only at the dawn of the 17th century when libraries opened separate catalogues to report and describe them. However, the first circumspect and general description belongs to the early 19th century, when Hain's *Repertorium* [s.d.], then considered as "the" masterly and final say, lists analytical entries of 16 thousand (!) early prints.

The unrelenting and discriminating research on early fonts (types) and watermarks (paper-types) cleared the terrain for further progress and, after a series of supplements and *errata*, it was finally Karl. W. *Hierseman*, a publisher in Leipzig, who led an international team to produce a "definitive" catalogue in 1925. At the time it was planned that this would contain about 145 thousand items; however, when the second world war broke out it had just successfully reached item no 7377. (*GW* 1925).

In this respect Hungarian librarianship has enjoyed an advantage. Possessing only slightly more than 7 thousand *incunabula* it is a heartening fact that G. *Sajó* and E. *Soltész* took the pains to complete their exhaustive analytical description, together with the photographic reproduction of all the title pages, at the publishing house of the Academy (*Cat. Inc.* 1970).

A first brief

How many books were printed during the 16th century? The answer depends on what we consider an item in its own right. Both Hain's 16 thousand and the German enumeration, planned to list about 145 thousand items, include not only the strictly speaking voluminous "books" but all the prints from the one-page calendar to the heaviest folio issues. They describe each and every edition, duplum and variant of the same book. It may have occurred that during the process of printing an error had been found and corrected. This would have caused a separate entry in the long list of *incunabula*. The number of books, as we would casually consider them now, as bound printouts of different texts would be but a fraction of the above numbers.

The Bible, for instance, appeared in no less than 129 variants, in various languages, but mostly in latin. Also "best seller" on the list was the less holy text "*Secreta virorum and mulierum*": that is, the "secrets of males and females". It appeared in no less than 48 editions. Its author, Albertus Magnus, was a prolific writer. He must have been much in demand, because his 20-odd books appeared in more than 200 editions, almost surpassing the classical authors (of whom Aristotle can be considered the peer) and the (then) neo-classicals, such as Thomas

Aquinas. The familiar assortment of a present-day book-seller thus appeared very early, though with greater religious emphasis.

The number of books actually printed in any given "edition" was a well-kept secret, as it is today. Yet it also happened, as it happens today, that some old sheets, gathering dust in the storage-room and difficult to sell, obtained a new title-page and were peddled as brand-new stuff: the pecuniary situation of the first printers and publishers must have been everything but rosy.

It would therefore seem to be absolutely impossible to estimate the growth rate of this new field with any reliability. Nevertheless, luckily for us the integral of an exponential function strongly diverges. This means that a slight change in the growth-rate causes an enormous difference in the integral.

If the publishing business grows at rate δ during b years, then there will be $\{\exp(b\delta) - 1\}/\delta$ books printed. There were b=45 years left from Gutenberg's Bible to the end of the century. A five percent growth would thus yield 170 books, a ten percent growth 890, a fifteen percent growth 5,687 and finally a twenty percent growth 40,510. Thus we may conjecture that the growth rate in the 15th century must have surpassed fifteen percent per year, but probably not the twenty percent threshold.

It must have been a very fast growth, a virtual "flare-up". Yet on second thoughts this is not surprising at all. In our age the same outstanding, eruptive growth rates are exhibited by almost every new invention of information technology. The record-player, radio or television, the computer or the fax-machine have spread with the same epidemic speed, and soon after their invention. It is not interest or demand that limits the growth in these early periods, but the (relative) lack of investment funds, the time constraints on production lines and the still missing know-how in marketing.

Nevertheless, such heady times do not last long and the market may become glutted after a while. The flow of new books also started to ebb by the end of the century. In the 16th century (to be investigated later in the paper and more closely) the growth rate was already much smaller. Here we base our conjecture again on some guesswork about simple orders of magnitudes.

The description of all the 16th century European prints were only planned by the guild of librarians. Thus we have even less data to put our fingers on than for the 15th century. (In Hungary the situation is better: we do have a detailed catalogue). However, some estimates were made by the librarians themselves to size up the task to be performed. They thought the effort would be about tenfold of that had been spent on 15th century prints. (*Borsa* 1974) In other words, the average growth rate could hardly have surpassed a 3 percent level.

A tenfold increase in the number of books follows from a yearly 2.3 percent growth. 3 percent per year means the stock grows twenty times. The librarians may have somewhat underestimated the task, but they would not have erred so much if they had reckoned with a yearly, say, 5 percent possible increase, as suggested by

Derek de Solla *Price* (1979). Such a growth rate would have caused a stupendous increase, rendering the stock of books 150 times as large as at the end of the 15th century. Librarians do not err with such immoderate margins.

The flare-up and gradual slow-down of growth can thus already be glimpsed from these very sporadic and uncertain data. A fluctuation of a *longer duration* seems to manifest itself, pertaining to the cultural and perhaps also to the economic life of Europe in the renaissance period. Nevertheless, we still do not know how long the slow-down took, how long the smaller growth rate persisted, and whether (later) a new upsurge did, or did not take place, thus altering the common pulse. We shall now try to inspect in greater detail data we happen to possess and are better acquainted with: namely, Hungarian catalogues.

Hungarian statistics

Incunabula

This academic publication, which has already been cited, contains about three and a half thousand diverse items. If we spoke above about seven thousand copies, this means that there remained, on average, two copies of each publication, kept by the various Hungarian libraries. Assessing them according to the date of their printing we arrive at *Fig. 1*.

If this sample, covering slightly less than ten percent of the total, is representative, then we can claim a virtual standstill for the first decade after the invention. Occasional books are published, i.e. they appeared infrequently. They come almost every time from a new, previously unknown printer's office. This is, then, the period of latency for the new contrivance that bursts out in an epidemic fashion between 1465 and 1675. The increase was almost incredible: one hundredfold over a mere ten years. Doubling every year in the beginning, later it yielded growth rates above fifty percent per year.

From the mid-1680s onward the tempo changes again perceptibly. A few sizable and reputable publishers, later known throughout Europe, start to stagnate. Under their leadership the growth rate slows down to a 3 percent per year, similar to the figure identified for the 16th century.

How trustworthy is our figure? I could have made errors when counting dates. I could have left out or misread publication years; yet, according to all probability, this would have occurred only in two or three cases. The librarians themselves could have erred when determining the right date of publication. The printer's printed description in the book, the so called "colophon", does not always contain the exact date of printing and there are cases *sine datum*, i.e. undated. Also, the printer himself could also have missed the right date (in one case, as discovered by a clever librarian, by a round decade).

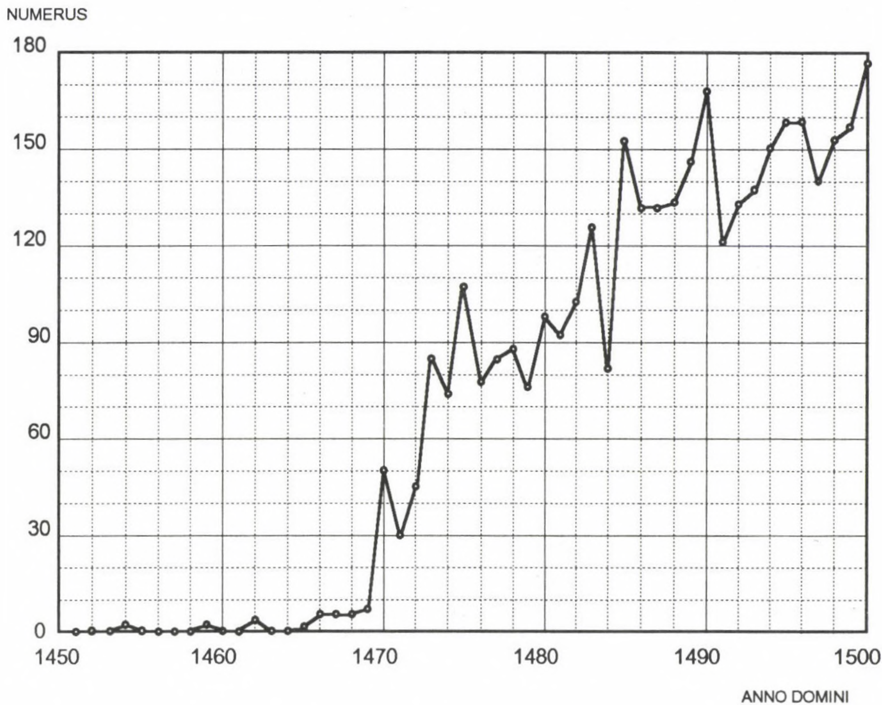

Fig. 1 Numerus incunabulorum

These errors, even if present, do not bias the graph in any systematic way. There is no bias even if the catalogue reports "*circa*", or "*non post*", or "*non ante*", indicating that the librarian was unable to date the book unequivocally and had to satisfy the reader with some limits. (I have therefore neglected the qualification, and taken the date to be exact.)

There are, nevertheless, some volumes dated for several successive years. Their printing probably lasted longer and in some cases may have overstepped New Year's Eve. (In such instances I took the earliest date). This may have caused some distortion, as the questionable specimen may also have been antedated by ardent librarians, wanting to possess or discover a previously unknown incunabulum. I sense bias around the threshold date: January 1 1501. However, this alters only the year 1500, and then slightly upward. All in all I trust the general picture and believe that the total population of incunabula (when, in the future, assessed and presented in a similar fashion) will show the same general trend and slow-down, together with a persistent but acyclic fluctuation around the trend.

This fluctuation is impressive, being close to 90 percent. In other words, the data and their fluctuation are of the same order of magnitude. Even a detailed analysis of the power spectrum did not uncover any outstanding cycle-length, as it usually does in the case of economic time series of the 19th or 20th century.

What does appear to be remarkable is the minor role played by any individual printer in the great upsurge. Indeed the market seems to prosper, while at the same time a printer could be suddenly ruined. The average printer-typographer stayed in business only for a couple of years, and seldom more than five. He prints 4–5, at most a dozen books and then disappears. His individual type-font may then reappear at a different shop (where in some cases he earns his keep as reader, correcting sheets).

I found but only three shops turning out books with any regularity and over a longer period: in Augsburg, Cologne and Venice respectively. They published three to six titles, regularly, year after year, and may have slowly accumulated a list of publications running into 50–150 items. Considering the capital-intensive technology, this must have required enormous investment. The selling price of a fine Bible stood at around 100–200 florentine forints (florenus) or german talers (thaler) would have been printed in a few hundred, at most, perhaps, thousand copies. At the same time a servant or a printing hand could be hired for 10 forints a year and even the bank-branch-leaders of the Medici house abroad did not earn more than a salary of 40 forints per year (*Hibbert* 1974).

The value (or price) of people and books stood therefore in a proportion we can hardly comprehend nowadays. The price level of books surpassed that of present day luxury cars, perhaps even that of flats, lodgings and mansions. The value of a library often overshadowed that of castles and fortifications.

Research has placed the costs Gutenberg incurred when printing his 42 line Bible at around four to eight thousand forints. The edition of probably 150 to 200 copies was still mostly unsold when Philippe of Nassau, during some altercation about inheritance, had to burn the city of Mainz. This is the main reason the world has inherited only 30–40 copies, partly damaged ones, of this admirable work. It may also have been one of the reasons why it was so difficult to make the new profession profitable.

By the time the printers' first font became worn—usually after a couple of thousand copies had been printed—hardly enough income had been received from sales to cast a new stock. The purchaser of the previous volume did not hurry to pay up, and creditors were not patient. Even when the printer was protected and backed by functionaries of the high clergy or royal benefactors, this did not prove sufficient. Even the latter's seemingly great power turned out to be too capricious and transitory to secure a business that had to invest sums and reaped its profits sometimes only after a ten to twenty year lag.

It is true that the printing and dissemination of information became much cheaper—but one had to spend much more on it and wait long years for the re-

ceipts in order to feel the benefits of this reduction. In all probability the printer's manufacture cost much more to establish and to run than copying chambers in the great monasteries with all their monks. Moreover, the know-how, so much needed in every profession, was missing, because the profession itself was virtually brand new.

Today, for instance, we know that bookshops (and in general, the book-trade) absorb large amounts of overhead expenses, running to twenty to thirty percent of the selling price. Gutenberg believed he would pocket every florenus of the, mostly imaginary, price within a couple of years. At least his legal struggles with the creditor attest to this, though he discovered the important distinction between credit offered to establish a printing workshop and credit needed to run it.

The breakthrough in ("revolution" of) information technology played tricks with the early inventors and participants, as it does at present. They invented and traded something genuinely new and marvellous but did not know and could not know its specific parameters, costs, availabilities, or time profiles. The rapture was that of the sorcerer's apprentice: half master, half slave of the new business.

Nevertheless, the book became, if not cheap, at least cheaper and more accessible. It was still only kings or heads of the great mercantile houses who could afford a library of a couple of thousand volumes. However, the lesser clergy started to lag behind with their holdings of a few dozen books. The cheaper books become, the more expensive the libraries.

Yet, already, the lay scientist or scholar could own the few books most important to him. He could enter into exchanges and could read at his own pleasure in the greater libraries of his well-to-do friends. This gave rise to the new type of *humanist*: the scholar and knowledge itself were slowly unfettered from the yoke of feudalism and religion.

2. Old prints

The prints which were either printed in or for Hungary methodically catalogued from the first Hungarian book up to the year 1635, as already mentioned (RMNy 1971 and 1983). This is one of the (very few) advantages of being a librarian in a small country with a rather particular language: the task is of a more manageable size. In addition, Hungary has also been lucky in always having skilled and dedicated librarians.

The age-profile is depicted in *Fig. 2*:

It is quite remarkable that the first Hungarian book, the *Chronica Hungarorum*, printed by Andrew Hess at Buda (on the Western enbankment of the Danube situated in what is the present capital of the country) appeared in 1472: that is, at around the time of the German and Italian upsurge in new technology. These were,

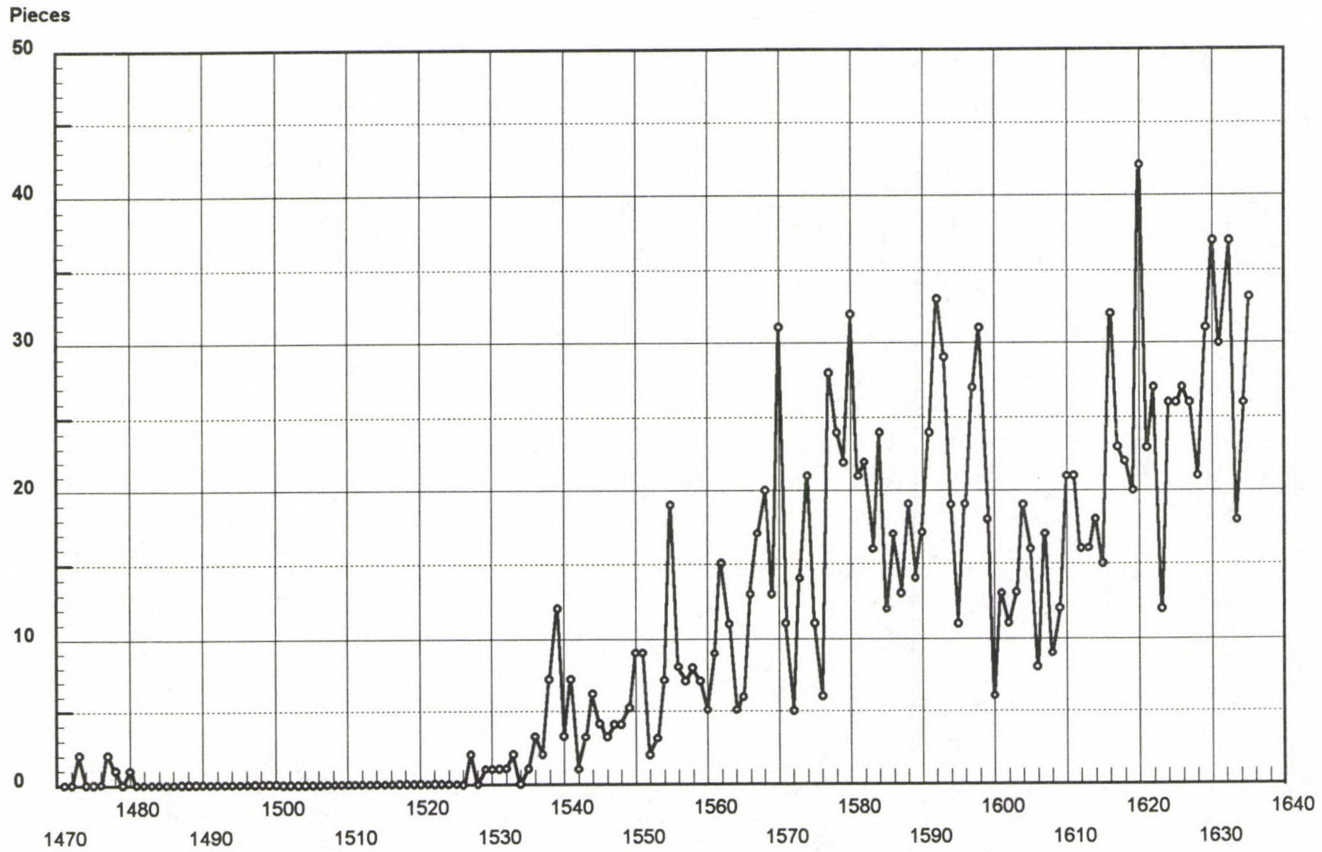

Fig. 2 Old Hungarian prints

as already mentioned, the times of our greatest renaissance king, Matthias. A few further prints of the same decade can be attributed to another printer; his name was not ascertained by J. *Fitz* and E. Soltész, the discoverers of this unknown but probably Hungarian follower.

Yet the originally relatively short follow-up period of less than two decades then turned into a lag of nearly 80 years, because the next prints appeared only after the Turkish occupation, at the end of the 1530s of the next century. This was not only the case with Hungary, but also Poland (and Warsaw was a place of peregrinage in those times for the intelligentsia).

The second distressing peculiarity is the complete lack of any printing boom or upsurge; there was no sudden burst of a new activity: the printing trade was "born old" in Hungary and instantly settled down to the already known circa 3 percent per year growth, with a volatility which certainly exceeded that shown in *Fig. 1*.

As far as such a strong dispersion around the trend allows, we can distinguish a slowdown of this anyhow sluggish development around the end of the 16th century and, if not a new spurt, then at least something of a new pulse at the dawn of the 17th century; this lasted until the last year catalogued, i.e. close to the middle of the 17th century.

In the first, Hungarian variant of this report I have been very sceptical both about the existence and the universal validity of a turning point in the fluctuations of the book trade. Now, after having read the report of *Estivals* (1992), I have somewhat more trust, having found some shred of evidence for the existence of the 200 year cycle.

In his words "On a ainsi montré que la production française (et probablement européenne) des livres depuis le 16e siècle était soumise à la loi mathematique de la courbe logistique dite en S: hausse lente du 16e au 18e siècle; hausse rapide au 19e siècle; hausse lente au 20e siècle, correspondant à des croissances en milieu fermé".

I know of no instance of escalated (superimposed or successive) logistical curves, brought forward by either nature or society. A logistical curve is made possible only by some final and irreversible saturation, or a limit that cannot be transgressed. If a new start of a new "logistical" curve is suspected then it may indicate the onset of a new cycle, hidden from the naked eye, by being superimposed on a trend line. Therefore, the process described for French book production may be a case of sequential cycles of an approximately 200-year duration, starting at the beginning of the 16th century.

Nevertheless, I am still hesitant, even if R. Estivals writes about a "cycle bi-séculaire du 18e au 20e siècle", proven by the periodicals that carry "l'Avant garde" in their title. Furthermore, I will remain sceptic as long as, for diverse European countries, the *existence* and also the *coincidence* of such 200 year cycles cannot be shown. Yet I now have greater hope, greater than a year ago, that this interesting question of existence will be decided or denied within the next decade.

In the Hungarian variant there is a separate chapter on the high correlation of the logarithm of GDP and the logarithm of the number of published titles in the postwar period: that is, from 1950 to 1992. I do not think this would be of any particular interest to the foreign reader, except that it, indeed, showed that book production is a fair proxy for GDP, the coefficient of correlation standing above 0.97.

I have been running the same correlation analysis for a cross section of various countries. This has proven to be disastrous and has been an indisputable failure. Upon closer inspection I found that the terms "book", or "title", or "edition" were very inconsistently used in the various statistics. In some countries, to qualify as a book, the item concerned has to be of a certain size or contain a certain number of pages; in others diverse authorities report on the prints sent in etc. For the time being the terminology and, therefore, also the statistical data, are hopelessly irreconcilable.

Conclusion

The results so far allow us to be satisfied with following partial outcomes:

1. In all probability the growth of the number of published titles does provide an approximate measure of the growth rate of a given country, including the ups and downs of the latter—*ceteris paribus*. Nevertheless, much more time series and more analysis is needed to claim anything concerning numerical measures of the goodness of fit, tolerances and dependability.

2. The existence of the 200 year economic cycle remains unclear. The upswing in the early 15th and early 19th century and subsequent slowdown in the next century is fairly unambiguous; the still unclear upswing in the early 17th century may be genuine—I, at least, could not disprove it. Future verification (or denial) should therefore centre upon this particular period. It may require additional data about learning and information in general: periodicals, universities, scholars and students.

3. The mathematical methodology of research is not yet final and still, necessarily depends very much on the data as they become available. I did formulate, and have even spoken about, tendencies as seen by the naked eye. Yet we know how misleading this may be. My report, therefore, is not very pioneering, even concerning methodology.

Nevertheless, the question of the existence or non-existence of the 200 year cycle is interesting and important in its philosophic and economic repercussions. It may be posed more succintly now and probably can be decided or at least approximated statistically during the next decade, when the age profiles of the great old libraries become accessible through computerization.

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REVIEWS

FOREIGN DIRECT INVESTMENT (FDI) AND PRIVATIZATION IN HUNGARY

J. HAMAR

I. FDI and economic transition

Macro effects

The study focuses on the measurable effects of FDI and the joint ventures (JV) in the Hungarian transition. Among the macro economic changes only those which are closely related to the effects of the FDI are dealt with here.

Rate of growth. In general, the liberalization of laws concerning FDI in any given country usually brings about a situation in which foreign capital inflow regularly starts to grow at a quadratic rate; this has been proved in several international cases, and it has also happened in Hungary.

However, in 1992, although the number of new JVs could not be considered negligible and FDI still increased by a large value of USD (Jan.-Nov.), the data clearly show a decrease in the growth rate (i.e. compared to the number of the JVs it started in 1991).

This pattern of the growth rate after liberalization can be considered as a 'natural' one. After some years of quadratic growth, the decline in the rate is obvious. (From almost zero level, the annual rate of growth could be doubled regularly in some years, but after a certain value—such as 1.5 billion $ FDI in 1991 in Hungary and in 1989 in Portugal, the decline could be foreseen.) It is an open question, as to whether this decline in Hungary is a symptom of a changing trend, or just a temporary fact (as it was in the Portuguese case).

Effects on the balance of payments. The net inflow of foreign capital has helped to alleviate the huge burdens of the foreign debt of the country year by year. This enabled Hungary to finance the interest payment on the debt without decreasing the financial sources available for the domestic economy.

This positive effect of FDI on the current balance of payments (CBP) grew five times between 1990 and 1991.

Akadémiai Kiadó, Budapest

In 1991, the balance of payments had a surplus of 265 million USD; the net inflow of FDI in cash (without the value of imported goods as initial capital of the new JVs) reached 1459 million USD, about the same level as the payment requirement on the interest of the foreign debt. (The stock of FDI in cash reached the level of 2107 million USD.) The net profit repatriation meant 32 million USD worth of spending.

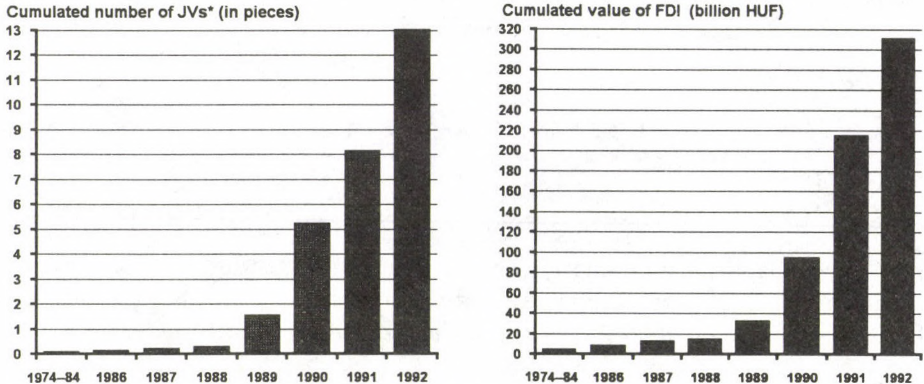


Fig. 1 Rate of growth of the JVs and FDI

In 1992 the positive effect of FDI on the balance of payments was still not negligible, but it was less than a year earlier (especially in the last quarter of the year). This decline—according to the National Bank of Hungary—was mainly due to the changing cross exchange rate.

At the end of October the stock of FDI in cash reached a value of 3208 million USD. However, in October, although the inflow still increased by 54 million USD, the value of the stock was less than it was in September, by 147 million USD. In November, a further 77 million USD was invested in Hungary, and the value of the profit repatriation (in eleven months) was equal to 42 million USD, while the surplus of the CBP reached 704 million USD.

Effects on the balance of trade. Theoretically, the economic liberalization of trade and capital has a negative effect on the balance of trade.

Following import liberalization the balance of trade can be expected to deteriorate, at least in the short run. The growing possibility for imports does not result in an immediate increase of exports, since companies need time to catch up with growing competition and global market requirements. If the liberalization of the traded goods happens simultaneously with that of the capital inflow, this effect is even stronger.

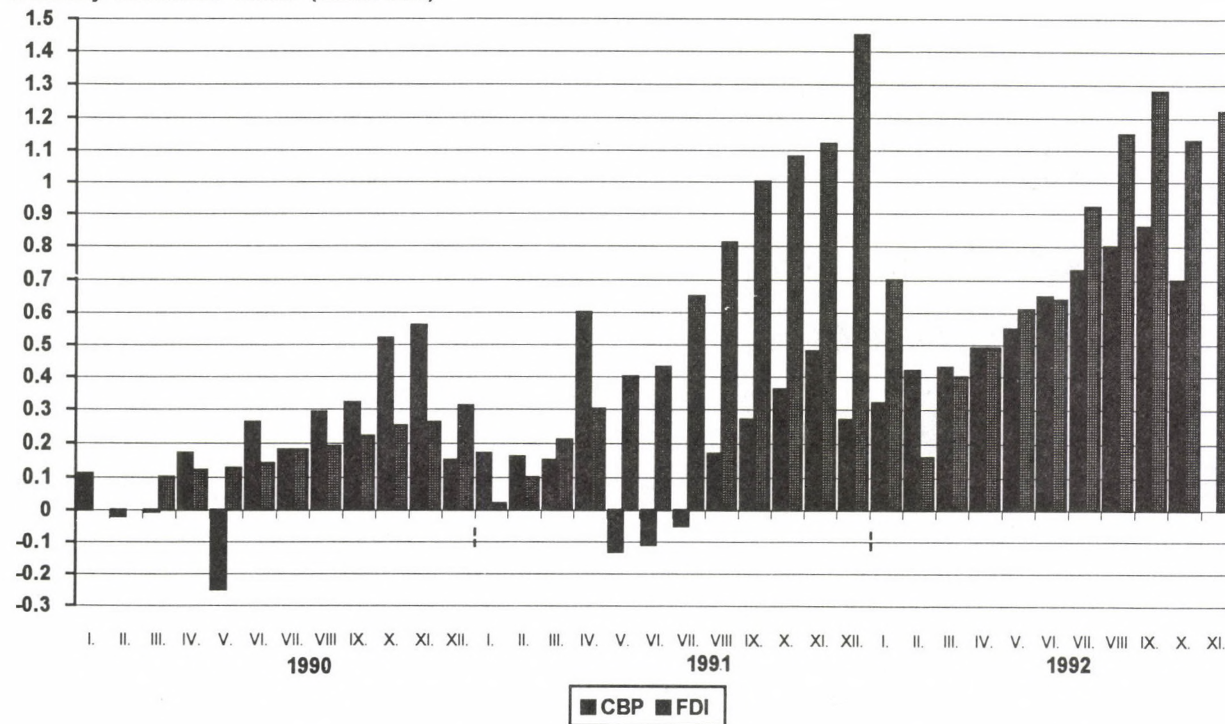


Fig. 2 Current balance of payments (CBP) and FDI

In 1993, though the value of FDI grew from month to month at almost the same rate as a year earlier, and by the end of 1993 with the value of the MATÁV privatization (876 million USD) it reached USD 5 billion (and 2 billion USD estimated FDI in kind, 7 billion USD altogether), it could not finance the deterioration of the balance of payments. (Ed. note)

The results in Hungary were quite different. Although since 1989 foreign trade had been liberalized in parallel with capital inflow, the jump in imports emerged only later (in 1991), while the exports grew at a fast rate.

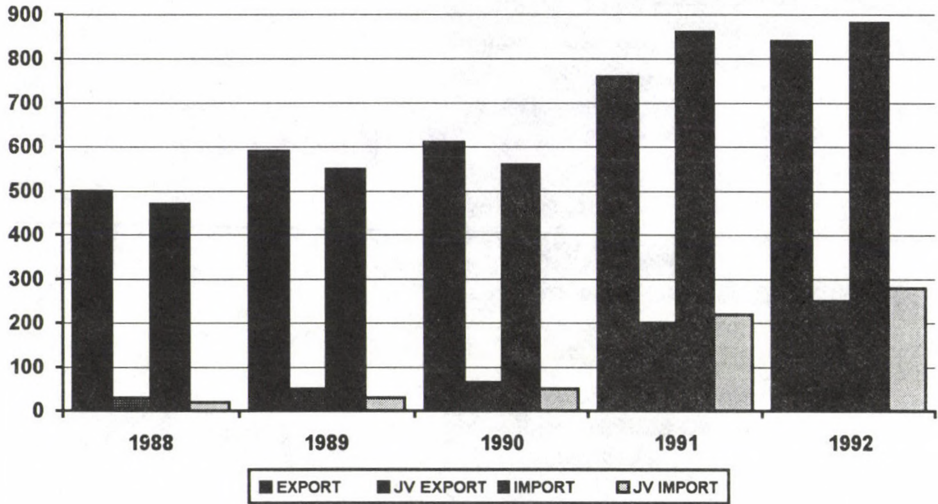


Fig. 3 Joint ventures (JVs) in foreign trade (billion HUF)

The postponed increase in imports was partially due to the gradual nature of the liberalization and to the fact that about a half of the whole turnover remained unaffected. This was because of the still existing COMECON trade, and it carried on until accounting in Rubels was replaced by the USD. However, the main reason for this specific phenomenon was almost certainly that Hungary continued to suffer from a long-lasting, and strong depression in overall home demand (i.e. falling standards of living, the state budget deficit, a fast decline in investment activities, and the liquidity problems of the firms did not enable enterprises to increase their imports at a fast rate).

On the export side, in the meantime, the collapse of the COMECON trade and the recession together produced a real 'shocking' effect, and this forced many companies to reorient their market structure.

Experiences of successful export-reorientation showed that it was mainly those companies which had direct links with western companies that were successful in this respect (first by subcontracting and later with JVs). On the other hand, some companies (which had originally specialized in trade with the Soviet Union or had dominated domestic markets) did not even start to analyze the causes of their failures and thus did not start to restructure their production and mar-

keting systems. There were also activities where the reorientation needed a much longer time (because of the nature of the activity, or technological changes).

In 1991, these facts were already raising questions about the possibility of repeating the fast speed of development in exports towards western countries. The decline in export growth (and also the decrease in its value in the last three months of 1992) disappointed all expectations.

This changing pattern of trade was certainly due to the continuing recession in the Hungarian economy, and to the changing cross-exchange rate. At the same time, the deepening recession in the western countries also had an important effect.

In this development the JVs have regularly had a much larger role than their actual proportion in the economy would apparently warrant.

In each year the activities of the JVs in foreign trade have been much more dynamic in exports and imports than that of the domestically-owned companies.

At the beginning of their activities the JVs contributed to the surplus of the balance of trade (see *Fig. 5, Chart 4*). However, in 1992, almost the total deficit was produced by JVs.

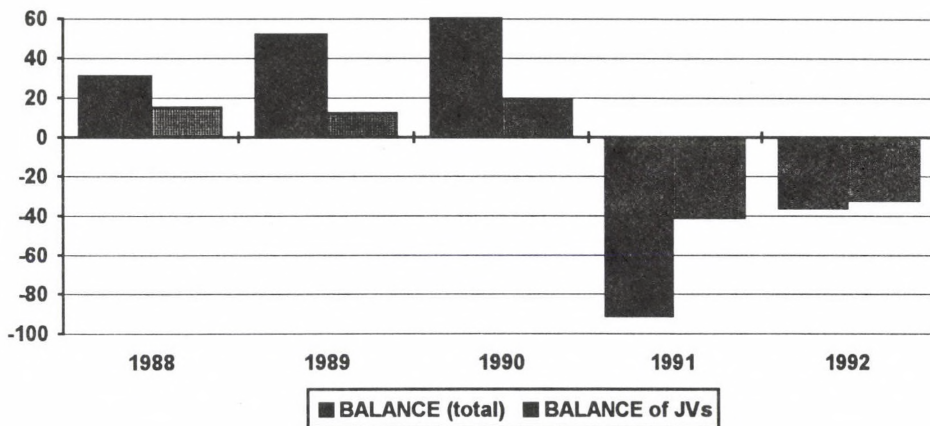


Fig. 4 JVs and balance of trade (billion HUF)

These facts underline some important effects of FDI (and the fast growing proportion of JVs in the overall turnover): namely, they were much more flexible when increasing their exports toward the western countries, but with the recession on those markets their activities were effected more strongly. (The almost total domination of the subcontracting types of activity of these companies partially explains their higher sensitivity to the changing demands.)

Their roles in imports also differ considerably from that of the wholly domestically-owned companies. The more dynamic increase of their imports is certainly due to their higher activity in investment (see the next part of this study). The most dynamic part of the increasing imports could be tackled in those investment goods which might signal a recovery.

The next section will provide some more insight into the activities of the JVs and also into their effects on micro-economic changes.

Micro effects

Changing characteristics of the JVs. This part of the study deals with the measurable effects of the JVs on the restructuring of companies, on their adjustment, on the changing ownership pattern, and on those new types of activities and abilities, which are necessary for firms to give themselves a market-oriented strategy. The latter are needed to make the companies competitive on the world market and to establish the necessary conditions for a market economy.

The methods were based on the same cross-table (static) analyses of the balance sheets of the firms applied earlier (Hamar 1991). These compared the performances of JVs with that of state companies. Now, having the data of three years (1989–1991), the dynamic changes can also be studied.

Corporate structure

The *JVs have had a crucial role in the development of small business, which had been seriously lacking in the Hungarian corporate structure. However, in 1991 a new phenomenon* emerged. *The increase* of the number *of small firms without FDI represented the most dynamic* part of changes in the corporate structure.

At the end of *1989*, the number of JVs already reached a total of 1349: in other words, 9.3 percent of all companies. Among the large companies (with more than 250 million HUF net turnover) the proportion of JVs was 5.6 percent, while the small JVs (with less than 250 m. HUF) had a share of 14 percent (1110 out of 9464 small companies).

The large wave of decentralization of the corporate structure became faster in *1990*. The splitting up of the big state companies and the establishment of new (especially small) firms were mainly helped by FDI. The number of JVs increased more than four times (to 5726), and at the end of the year their share in all companies operating with foreign capital was 20 percent (1/4 in the sphere of small business and 1/10 in that of big companies).

This tendency continued in *1991*: the number of all companies operating with foreign capital (including the number of JVs) almost doubled again (from 27,840 to 44,990; and the number of JVs from 5726 to 9117).[1] However, an important new phenomenon emerged in that it was small business without FDI that grew at the fastest speed!

Property structure

The role of JVs in the transformation of the property structure and in the capital flow necessary for restructuring the economy can also be considered significant.

The stock of the FDI (in USD) working in the JVs had already reached the value of 29.3 billion HUF by the end of 1989, (i.e. 1.1 percent of the total national stock of capital). The increase to 208 billion HUF (by the end of 1991) meant an 8.5 percent share of the stock of FDI in the stock of initial capital in all companies. Out of the 8313 small JVs, FDI accounted for more than half of the initial capital invested in these businesses. This extra source of finance also gained a significant share in the assets of large firms (the ratio increased from 21 percent to 41 percent between 1989–1991).

Although the proportion of the JVs' capital stock in the total stock of all companies was negligible in 1989, 38 percent of all existing shares (and 45 percent of the stationary capital) already belonged to the JVs. (In small businesses these proportions were: 10 percent; 17 percent and 33 percent, respectively.) However, this tendency continued in 1990 (when one half of all shares belonged to JVs). A year later an opposite tendency emerged: the JVs lost their relatively high rates of shares in all groups. (The rate of shares of the JVs became 1/3, or less than 40 percent of the total by the end of 1991.)

This phenomenon is certainly due to the different privatization programmes launched by the State Privatization Agency (SPA): for example, the programmes launched for the small restaurants and trade units, for increasing the number of companies transformed but not yet privatized, and for splitting them by a partial buy-out by the employees. To a certain extent, this can be proved by the different tendency in the characteristics of the company groups, according to the types of employment which they offer.

[1] These numbers include all companies presented in the official Balance Sheet Formula.

Employment

While in the whole economy the number of employees decreased by 15 percent (between 1990 and 1991), it increased by 18 percent among the JVs. Among the large companies the differences were more significant (a 30 percent decrease on average, while the JVs were employing 22 percent more persons than a year earlier). It is a special fact that the number of employees increased at a more dynamic rate at those small companies which were operating without foreign capital than at the small JVs (113 percent versus 105 percent).

Efficiency

A significant increase in the efficiency within the operation of a firm is a usual expectation as a positive side-effect of FDI. However, the results of such an improvement usually emerge only a few years later. This is one of the main reasons why governments usually give tax-allowances or total tax exemptions to new ventures during their initial years.

The experiences of the activities of JVs in Hungary are rather diverse. There are companies where the new foreign owners have not even started any restructuring efforts to improve the performance of the company; nevertheless, they have taken huge amounts of profit (sometimes more than the invested amount) out of the country. On the other hand, others started to develop new activities at once, or to introduce a market oriented strategy.

When analyzing the performance of JVs it could already be seen in the first year of their operation that, *in general, they used less production factors, less stocks and had lower net rates of income, and produced relatively more profit and less losses, than the national average! (This was especially the case with the small JVs.) The investment activities of the JVs were much more intensive than that of domestic enterprises.*

These advantages were also present during 1990 and 1991. The investments of small JVs accounted for 40 percent of the total (in 1990), and one half of the whole amount invested by small companies. The ratio of large JVs in investment had increased from 10 percent to 25 percent by the end of 1991. Concerning profit rates, the JVs produced higher profits, with these having less share in net income and in that of the production factors (relative to the same ratio concerning all companies in each company group).

The advantages of the performance of JVs over other types of enterprise clearly *diminished in 1990*, both in the large companies and in the small ones. In fact, one really surprising change *in 1991*—contradicting all rational expectations—was that *the small JVs lost almost all of these advantages over small firms operating*

without FDI. The large JVs produced 24 percent of the profit of all large companies. In contrast to 1989, the relative proportion of JVs in all losses in 1991 extended to their relative shares in profits. (The JVs produced 27.5 percent of all losses in 1991.)

One explanation for this phenomenon relates to the overall effects of the recession. Experiences from several cases surely prove the existence of the activities of multi-national companies (MNCs). These are well-known from international theory and include the avoidance of paying huge tax- and wage burdens by the MNC's. MNCs took the profit out of Hungary as the price differences in the exported and the imported goods. One of the reasons for this might be the fact that the government decided to diminish the loss of the budget income by abolishing future huge tax-allowances to the JVs.

Tax-allowances

The early positive results in the performances of JVs were, to a certain extent, due to the generous *tax-allowances* given to those who could involve more than 5 million HUF worth of foreign capital (that is, up until 1990).

The ratio of tax-allowances in the tax bill of the JVs was high. It was more than 60 percent in both groups (in the large and in the small JVs alike). However, the ratio of tax-allowances given to JVs in comparison with the total amount of taxes paid by all companies was only 3 percent. The ratio of tax allowances given to the small JVs to the total tax paid by all small companies was higher (8 percent). However, *the taxes paid by the small JVs dynamically increased the tax income of the budget!*

The importance of tax preferences had increased by 1991: the amount of the tax-allowances given to all JVs extended that of their paid taxes by 22 percent. However, the small JVs increased the budget income at the most dynamic rate and, relatively, they also got the less preferences in that year. (The ratio of tax-allowances over paid taxes was 70 percent in the case of the small JVs.) At the same time, the large JVs got around half of all tax preferences given to large firms. This sum was 151 percent of their paid taxes. This differentiation according to the size of companies partly explains the better results in the performance of large JVs.

Cost structure

The JVs had liberalized wage- and price-regulations even in 1989. This enabled them to raise wages significantly (some gave more than 60–70 percent wage-increases). However, overall data for the JVs shows relatively less spending on

wages than the national average. According to the cost structure of the JVs in comparison with the national average, *they usually economized with all factors* (with the exception of the amount spent on advertizing and trade promotion).

At the beginning of the period small businesses conducted mainly those activities which required less spending on materials and fixed capital, but more on wages compared to the large companies (see the data for 1989). The JVs (in both company groups) had significant advantages in connection with wage rates, this being due to their different way of production organization. (This refers to the fact that they contracted out several activities and services instead of producing them inside the companies.) The large JVs spent relatively more on materials than the national average. This might be because they had a better liquidity position and the fact that they could more easily import certain goods that had not been liberalized at that time.

The comparative cost-structure analyses revealed some *significant changes* in 1990–1991. In general, the main *differences that characterized the different groups* of companies in 1989 gradually escaped notice, *especially between the JVs and the companies operating without FDI*.

The rate of *material costs diminished* significantly *in* the cost structure of *all groups* (maybe as one of the results of import liberalization and also due to the effect of the growing proportion of subcontracted foreign trade activities). It was reduced to one half in small business over two years!

It is worth paying attention to how radically the wage-cost rate decreased in the small companies, especially in the JVs: the figures were 10 percent and 7 percent, respectively. At the same time, the large companies spent the same rate of their costs as earlier and the large JVs increased their wage expenses slightly.

Another significant change in 1991 was that the rate of fix costs (to finance company administration, energy, public services, rents, etc.) of the large companies (especially the JVs) increased considerably. The small companies turned out to be more flexible. They could reduce their fixed costs but they still spent a lot: the rate of fixed costs paid by the small companies diminished from 48 percent to 42 percent (the size of the decrease in the small JVs was represented by a fall from 68 percent to 47 percent!).

Contribution to the state budget

The JVs had a significant effect on the links between the state budget and the companies. As the JVs emerged the non-normative links (supports and "take off") with the budget suddenly diminished. However, the remaining or newly-established elements of the budget benefits facilitated rather those who invested in large companies: the small JVs paid 17 times more to the budget that they got in

any form of support. This rate was only 2/1 in the case of the large JVs. (In 1989 the large JVs contributed 1.3 percent of the budget net income coming from the big companies, while the small JVs paid 3.3 percent of the net budget contribution of small businesses.)

In the following year all companies paid much more to the budget than a year earlier, (or more than the amount of the support they got). The net budget contribution of the small JVs was 8 times greater! (It was 22 times greater than the support they got in 1990, especially with reference to their export activities.)

In contrast, *in 1991 only the large companies increased their net contribution to the budget. All other groups diminished strongly the gap between their payments to the budget and the support they could get from it*. The growing contribution of the large companies was a result of the fact that the state supports given to them were felt more strongly than the payments of the companies. The narrowing gap between the budget contribution and support given to small businesses was due to an increase in the export support. However, their contribution to the budget still increased at a dynamic rate (137 percent, and the small JVs 144 percent).

Sectoral structure

A frequent criticism of FDI is that it is the '*gamblers*' (who want to gain huge profit in a short time with minimal investment) who invest in Hungary, mainly in trade and services. The 'honest', 'quiet' investors (with long-term interests) can be found among those who invest huge sums of capital in industrial production.

The results of 1989 only partly prove the above assumptions. It is true that the proportion of JVs according to their numbers was already highest in trade (1/5), and the rate of growth was highest in services. Yet, according to the existing number of JVs and the amount of capital inflow, the industrial branches were already dominant.

This tendency has become more characteristic since then (see *Fig. 5*).

The main reasons why FDI focussed first on trade and services can be derived from the 'nature' of capital: *foreign capital*, according to its 'nature', *flows to those territories where the return is expected to be the most spectacular*.

The traditional structure of the Hungarian economy also attracted FDI to these sectors, since these activities were regularly neglected (or absent), and certainly much more monopolistic. This meant a larger possibility for gaining extra-profit. However, in the first year of the JVs their results were already indicating that *the more spectacular the anticipated return, the more risky, and the more possible the failure was*.

As the import liberalization went on, so the number of traders increased, and in this way competition increased strongly. As shortages almost disappeared—as

most of the manufacturers realized in 1991—the possibility of gaining extra profit was greatly diminished. Besides, government efforts to attract large investors to industry also affected the sectoral distribution of FDI.

Over the past few years the changing pattern of the origin of investors has also had an important role: since 1990, the United States has invested the largest value of FDI in Hungary.

The changing sectoral characteristics of JVs also certainly show that they have a much greater degree of flexibility: they have the ability to quickly change their activities as one of the segments (or sectors) becomes saturated (or is supported less by the regulations or by the state). *Their success can be explained by the fact that they have been able to integrate those activities which were traditionally totally separated in the centrally planned economy, such as manufacturing, home and foreign trade.*

To summarize the main effects of the JVs at the micro-economic level we can see the advantages of the new way of production organization and the market strategy launched by them. By contracting out several activities, by operating at the level of global markets and in different activities, they were able to adjust much faster to the changing market conditions. Their activities in foreign trade and investment have been more intensive and the collapse of COMECON trade affected them much less than other types of enterprise in the national economy.

However, the more room the JVs gain in the economy the less clear cut are the differences that can be measured between their performances and the overall tendencies. It is still not clear whether this—otherwise natural—phenomenon can be considered a result of the diffusion of the positive changes or rather the opposite case—i.e. that the JVs have also learned how to use preferences, how to avoid taxation, and how to put pressure on decision-makers. Both directions can be recognized and proved by the facts shown in this study and certainly by several practical case studies. (Such case studies have looked at the different treatment given to large and small scale companies by the state and the regulations. The fact that small businesses operating without FDI seem to catch up with the performances of JVs might be a signal of the learning abilities of home economic actors.)

Policy consequences

As all theoretical evidence proves, neither privatization nor FDI can solve the problems of transition, but they can contribute to reaching the main goals.

The results of Hungarian privatization so far are not too significant. However, the 'learning by doing' process has revealed several deficiencies and although some of them have been overcome, most of the assets still belong to the State, the property structure is more confused as ever, the 'real owner' has rarely been found, and

Chart 1: 1989 JV (pieces)

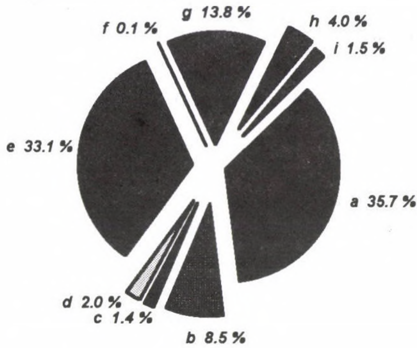


Chart 2: 1989 FDI (billion HUF)

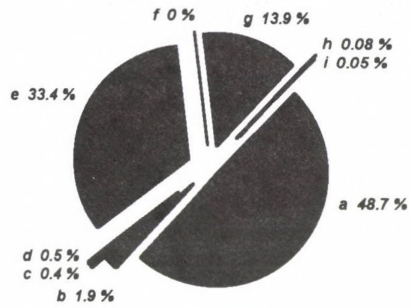


Chart 3: 1990 JV (pieces)

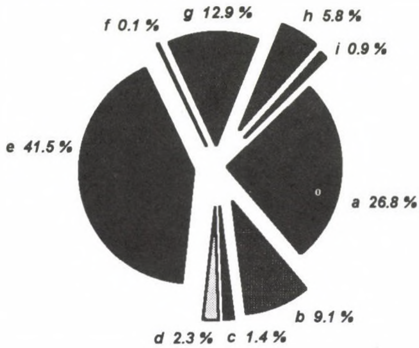


Chart 4: 1990 FDI (billion HUF)

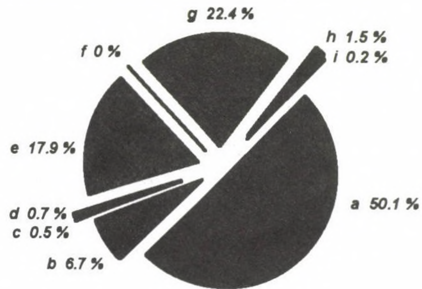


Chart 5: 1991 JV (pieces)

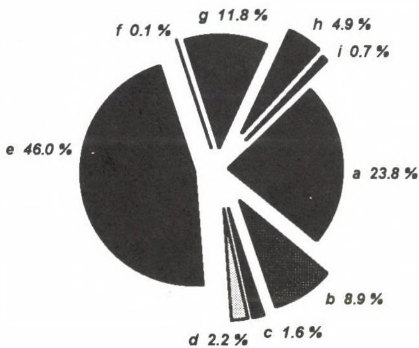
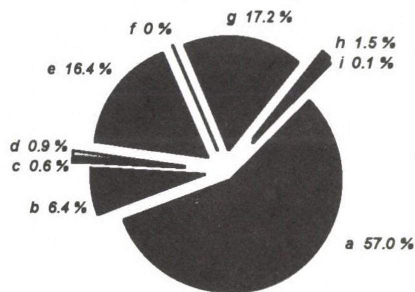


Chart 6: 1991 FDI (billion HUF)



a: Industry, *b*: Construction, *c*: Agriculture, *d*: Transportation, *e*: Trade, *f*: Water supply, *g*: Material services, *h*: Health & social services, *i*: Public services

Fig. 5 Number of JVs and the level of FDI by sectors (1989–1991)

some of the former dominant market positions have been maintained. Nevertheless, despite the lack of a coherent and clear concept, some important positive changes were launched with the development of small businesses and by the positive effects of decentralization, together with the macro-economic changes. "Spontaneous" privatization can be considered as a necessary but not sufficient initial step to FDI.

The positive and negative effects of the process can be measured by looking at the case of JVs.

At the macro-economic level, fast growing FDI has facilitated the financing of debt burdens without taking resources out of the country. How long this effect can be maintained certainly depends on the macro-economic policy. It can be shortened by a hectic, frequently changing governmental policy and postponed by a clear, long-lasting coherent one. However, the nature of the FDI forces us to reckon with its decreasing positive effects on the balance of payments (BP) with the fact that the net inflow of the foreign capital cannot forever keep up a quadratic rate of growth, and the profit repatriation will also certainly grow.

At the micro level, the experiences of the JVs can be considered rather contradictory; however, their crucial role in the transition cannot be denied. They have launched positive changes necessary for integrating the economy into the world market, for establishing the main conditions for competitiveness, for eroding traditional structures and regulations, and for increasing efficiency and adjustment ability.

FDI has already become important in those activities which have usually been neglected or even absent in the traditional structure of the Hungarian economy (such as foreign trading companies in home trade, or in health, cultural or public services, consulting, information etc.).

FDI has contributed to the development of small businesses, to the involvement of private entrepreneurs in foreign trade and in taxation. By making 'grey' or 'black' activities legal—at least taxed and registered—their contribution to making the Hungarian economy healthier is significant (at least it was at the beginning).

Its role in changing inter-firm partnerships cannot be neglected either. Several examples prove that JVs organize their activities in flexible, horizontally built systems, based on national and international cooperation. This is very different from the traditional production organization system with closed, hierarchically and centrally managed links.

Another important experience is that the activities of the JVs cannot be managed by the old methods any longer. However, they certainly have more ability to avoid the government, or to force it to change the rules they do not like.

The fact that FDI flows—according to its nature—into those activities where the profit margin is high and the return on capital is prosperous contributes to the correction of distortions in the rate of production factors, and to the increase in the efficiency of resource allocation. However, this will stop if the government interferes again, and there were already signals of this effort in 1991.

The surviving elements of the traditional policy-making structures seem to have gained more room, and there is a danger that the cessation or retardation of the positive changes could come onto the agenda. This is certainly possible if, due to the pressure of deepening economic crises and growing social tensions, the government cannot resist the temptation following the strong lobbies arguing for protection.

The negative effects of FDI shown by this study can only be overcome if the policy-makers establish a long-lasting clear policy based on a large consensus, not differentiating among investors (home or foreign, industrial or other), but giving indirect help to them (helping them to reach proper information, providing small scale but fast bank services, etc.). To build up confidence and encourage the long term strategic interest of investors requires a strengthening of economic and politic stability, a lowering of tariff- and tax rates, and the prevention of 'black or hidden' activities. These conditions would be helped by improving controls and extending the circle of taxpayers, by solving liquidity problems, and by ending the undisciplined financial behaviour of companies.

Otherwise, the future of FDI will not only become uncertain, but those positive changes that have been experienced so far and which are necessary for a healthier economy, will also be stopped. All (home, foreign, small or large) companies will try to find huge profits without making too much effort to improve their cost-structure, efficiency, technology or their innovative abilities.

The government should learn that only with growing competition (that is demonopolization) can companies be forced to behave in a way appropriate for a market economy. Then the state would only need to interfere if the political stability in a certain region or certain economic branches made it unavoidable.

Reference

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Appendix

The number of JVs and the value of FDI (1974–1992)

		Number of JVs (units)	FDI paid in convertible currencies (billion HUF)
1974–1984	stock	28	2.6
1985–1986	stock	32	3.7[a]
1987	flow	44	3.5
Total: 1.1.1988	stock	104[f]	9.8[b]
1988	flow	104	4.2[c]
Total: 1.1.1989	stock	208	10.2
1989	flow	1,141	19.2
Total: 1.1.1990	stock	1,349[d] (1,245[f])	29.3[d]
1990	flow	3,814	25.3
Total: 1.1.1991	stock	5,163[e] (5,059[f]) (5,726)[d]	54.7[d]
1991	flow	5,642[e] (4,390)[d]	153.0[e] (118.9)[d]
Total: 1.1.1992	stock	11,335[c] (10,701[f]) (9,117)[d]	207.7[d]
Total: 1.1.1993	stock	14,702[f]	...
Total: 1993 at the end of June/93	stock	15,311[f]	274.9[f]

[a]Including 3 large banks (CIB, CITY, UNIC BANK): 3.04 B HUF
[b]Sources till 1987: „Külföldi részvételű vegyesvállalatok Magyarországon", (MGK 1987),
[c]1988: Tribune for Firm Registration,
[d]Firms' balance sheets
[e]Calculations of the Foreign Trade Ministry, (NGKM)
[f]Central Statistical Office (1992)
Source: Hamar (KOPINT 1991)

ATTITUDES TO THE PRESENT ECONOMIC SITUATION IN SLOVAKIA

I. RADIČOVÁ

This report brings together findings of the survey "Current problems of Slovakia after the split of the Czech and Slovak Federative Republic (ČSFR)". This survey examined political change, economic development and nationality issues in independent Slovakia. It was conducted by the Center for Social Analysis in Bratislava. The fieldwork was carried out between March 12–21 1993, using a sample of 11,320 respondents from the Slovak Republic (SR). Standardized face-to-face interviews were conducted by trained fieldwork interviewers. The respondents constitute a representative sample of the inhabitants of Slovakia with regard to sex, age, education, nationality, size and place of residence. The survey is accurate within ±3 percentage points. Sampling error rates vary across subgroups of the general population sample (according to age, education, etc.).

The survey was sponsored by the National Endowment for Democracy, the American Jewish Committee and the Milan Šimečka Foundation, Bratislava, Slovakia.

General situation and the course of economic reform

One of the reasons for the dissolution of the common state of Czechoslovakia was the divergent economic development in the Slovak Republic (SR) and the Czech Republic (the economic reform involved harsher social implications for Slovakia) and the differing attitudes to economic reform and the process of privatization (lower trust of the Slovak population in the federal scenario for radical economic reform).

Leaders of the HZDS (Movement for a Democratic Slovakia) based their election success on the criticism of the "federal" reform scenario. They promised to change its principles. Parliamentary elections showed that these promises raised a considerable response among the population. In September 1992, three months after the elections, 61 percent of the citizens of Slovakia believed that the principles of economic reform should fundamentally change; only 14 percent of the citizens were in favour of continuing with the radical "Klaus-styled" reform.

The year that has gone by since the 1992 parliamentary elections has brought disillusionment and disappointment for the population of Slovakia. In March 1993, 71 percent of respondents reported that their economic situation had become worse;

only 17 percent consider it unchanged and 8 percent improved. 68 percent of the citizens of Slovakia fear further economic decline and poverty in Slovakia. 74 percent also note a deterioration in the financial situation of their families compared with the previous year. These evaluations are in sharp contrast with the optimism of the pre-election atmosphere.

Today, the dissatisfaction and frustration of people is reflected in their critical evaluation of the economic policy of the present government. Comparing it with that of the government led by J. Čarnogurský, only 19 percent of citizens believe it is better; 36 percent think it is practically the same, 38 percent even think it is worse. 84 percent expect the current economic policy of the government to bring wealth only to a few individuals and poverty to most people. Only 32 percent of the respondents have hopes of a better life for themselves and their families.

For people in general, the economic policy of the present government lacks transparency. 54 percent of respondents believe that the economic reform is still in progress: according to 8 percent of them, it has not swerved away from its original course, 31 percent assume that it has only taken a slightly different turn and 15 percent are of the opinion that it is now following a completely different direction. According to 28 percent of respondents, the reform has virtually come to a halt.

Thus almost 40 percent of respondents do not see major differences between the reform that was going on before the elections, and the reform that is going on now. They viewed Klaus's reform as a synonym for falling standards of living. However, because living standards have failed to stabilize even now, they have the impression that radical economic reform still goes on in the same way.

Most inhabitants of Slovakia cope with their impaired economic situation using traditional means: they reduce their expenditures, "tighten the belts" (71 percent), use the "do-it-yourself" system (46 percent) or draw on their savings (34 percent).

Less frequently, they use alternative, innovative strategies like setting up their own businesses (4 percent), taking on a second job (10 percent) or producing marketable goods (9 percent).

Types of economic expectations

The respondents were asked to assess possible developments of the economic situation in Slovakia from different angles: they tried to estimate the readiness of the advanced countries to make investments in Slovakia, and the risk of "selling out" Slovakia to foreign capital; they reflected on the activities of foreign mafia laundering "dirty money", the likelihood of strikes and social unrest, of economic decline and poverty; they assessed the possibility of turning Slovakia into a "second Switzerland", into a prosperous bridge between the East and the West, and of

accession of the Slovak Republic to the European Community together with the other countries of the Visegrad Group. The findings were then used to identify the following five categories of expectations concerning the economic future:

1. catastrophists—people with 0 or 1 positive expectations—36 percent
2. pessimists—people with 2 or 3 positive expectations—33 percent
3. balanced—people with 4 positive and 4 negative expectations—13 percent
4. optimists—people with 5 or 6 positive expectations—14 percent
5. illusionists—people with 7 or 8 positive expectations—5 percent

Negative (catastrophic and pessimistic) expectations concerning the economic future of Slovakia thus prevail strongly in today's Slovakia.

Economic expectations and attitudes with regard to the creation of the independent Slovak Republic

More optimistic economic expectations are, as a rule, found among people who welcomed the division of Czecho-Slovakia. "Illusionists" and "optimists" are pleased with the creation of the independent SR (80 percent of "illusionists" and 63 percent of optimists); they believe that the division has opened up new possibilities for the citizens of the SR. Had there been a referendum, 90 percent of "illusionists" and 62 percent of "optimists" would have voted for the division of the country. Both categories are convinced that the break-up of the ČSFR reflected the desire of the Slovak people to have their own statehood. At the same time, they believed it was also a consequence of the Czech reluctance to form an equal partnership with the Slovaks.

On the other hand, the "pessimists" and the "catastrophists" are concerned about the consequences of the division of the state (80 percent of "catastrophists" and 63 percent of "pessimists"). Their prevailing feelings about the dissolution of the ČSFR and the creation of the independent SR are fear, sadness and confusion. If there had been a referendum, most of them would have voted against the division of the country. According to most of them, the decision to split the ČSFR was not democratic (80 percent of "catastrophists" and 70 percent of "pessimists" believe a referendum would have been the right way). They believe that the break-up of the country was not inevitable. The division itself was too hasty and ill-prepared (85 percent in both categories). According to 88 percent of "catastrophists" and "pessimists", the division has further deteriorated the economic and social situation.

The category of "balanced" includes, as the name suggests, a middle-stream group characterized by mixed feelings about the division of the country—confusion and joy, fears and expectations of new opportunities. In a referendum, 40 percent of them would have voted for the division of the country, 33 percent against it.

Economic expectations and political attitudes

Prevalent among "catastrophists" and "pessimists" is a negative evaluation of the government's economic policy; they consider this policy to be worse than that of the previous government. In other in inverse proportion to the prevailingly positive one of the words their evaluation is "illusionists".

The distribution of trust in the top political institutions shows a similar pattern. The "illusionists" have an almost 100 percent trust in the President, Government and National Council of the Slovak Republic. Most "catastrophists", on the contrary, do not trust the Parliament and the Government.

The President of the SR has the confidence of the majority of representatives of all five categories: 65 percent of "catastrophists", 79 percent of "pessimists", 90 percent of "balanced", 95 percent of "optimists", and 96 percent of "illusionists". It is evident that the institution of the president could play an important role as arbitrator in situations of conflict and social tension.

Negative economic expectations are also projected into a more critical evaluation of the present system compared with the pre-November 1989 system. Two thirds of "catastrophists" and one half of the "pessimists" believe the current political system has more flaws than the previous one; inversely, three-quarters of the "illusionists" consider it to be better. Among the "optimists" and "balanced", the pendulum swings more towards the advantages of the present system as opposed to the pre-November regime.

The "illusionists" and the "optimists" include primarily supporters of the HZDS and SNS (Slovak National Party). The more positive economic expectations of citizens are, however, also linked to their social status: it is among the "illusionists" and the "optimists" that we find a higher representation of private entrepreneurs, and people employed by or helping in private firms. Their assessment of the living standard and financial status of their families is, compared with other categories, much more positive.

The "catastrophists" and the "pessimists" are interlinked not only by their pessimistic economic expectations, but also by their negative attitudes to the division of the country and lack of trust in the present government.

The critical expectations of the "catastrophists" and the "pessimists" do not necessarily imply a rejection of economic transformation and a market economy. The "catastrophists" and "pessimists" can be subdivided into two subcategories. The first of these is characterized by marked economic frustration and a preference for strong state interventionist policy, including a strong social policy. Their political preferences are represented primarily by the Party of the Democratic Left (SDL). The second subcategory includes people with liberal-conservative beliefs having political inclinations towards parties from the previous government coalition (i.e. the Christian Democratic Movement and the Civic Democratic Union). This subcategory also includes an above-average proportion of respondents of Hungarian

origin, including supporters of the Hungarian Democratic Movement, Coexistence, and the Hungarian Civic Party (MOS).

Opinions concerning the role of the state

The former Czecho-Slovakia had a strong economic role for the state. Despite the developing market economy, public support in Slovakia for state interventionism is still very high. Among Slovakia's population, egalitarianism continues to command strong popularity. Only 24 percent support the idea of widening the income differentiation.

Opinions concerning state and private ownership are balanced and rather stable: according to 43 percent of respondents, state ownership of enterprises should dominate; in contrast, 45 percent prefer private ownership. The strongest adherence to the idea of state ownership was found among voters of the SDL; the most pronounced support for private ownership was among voters of the right-wing parties.

Although unemployment is no longer a new phenomenon in economic life, the proportion of people who think that the state has the obligation to secure jobs for each individual according to the individual's skill level has not decreased (67 percent in May 1991; 65 percent in January 1992; 73 percent in March 1993).

Economic attitudes and the role of state

The attitudes towards economic reform expressed in election programmes show that the orientations of parliamentary parties in Slovakia can be characterized as follows:

a) liberal-conservative orientation: KDH
Co-existence[1]
SNS

b) social-market orientation—state-controlled privatization: HZDS

c) socialist and/or state-paternalist orientation: SDL.[2]

[1] Hungarian Democratic Movement, Co-existence

[2] Party of the Democratic Left

None of the key political parties in today's Slovakia have any doubts about the necessity of adopting a mixed ownership type economy. However, their views differ with regard to the role of the state. The HZDS considers state paternalism to be an inevitable component of transition to a market economy and assumes that the role of the state in the economy will gradually be restricted to a supporting role, through speeding up privatization. The KDH stresses just the opposite—i.e. the trust of the people in their own initiative and resources. The SNS emphasizes the role of the community and of the individual. The SDL emphasizes the power and interests of the collective, the group, the social group, class, and the idea of "state providing help to enterprises".

What do the people of Slovakia think about the role of state in the economy? According to the distribution of respondents' responses, the electoral victory of the HZDS and the representation of political parties in the parliament corresponds to the distribution of people's ideas about principles of economic functioning and social policy.

These ideas were measured in our study by means of the positive or negative replies of respondents to the following six statements which, according to the reliability test, measure the common concept "the role of state":

1. "Public ownership of enterprises should prevail".
2. "The state should ensure jobs for everybody according to his/her skills".
3. "The state should play a greater role in officially setting prices".
4. "Income differentials should be reduced".
5. "Everybody is responsible for his/her poverty".
6. "Privatization will be beneficial for everybody".

On the whole, three orientations can be distinguished.

The socialist orientation (state-paternalist orientation) was held by 43 percent of respondents who, at least in five cases, expressed their agreement with the first four statements and disagreement with the last two statements.

10 percent of the respondents opposed to the state paternalistic orientation were of a liberal-conservative orientation. Only one person from this group expressed agreement with the first four statements and disagreement with the last two statements—i.e. rejected state interventionism.

48 percent of the sample population can be placed in the middle between these two poles; that is, they displayed a mixed, social-market orientation (i.e. respondents who in the minimum of two cases and the maximum of four cases expressed their agreement with the first four statements and disagreement with the last two statements).

Opinions concerning the role of the state and attitudes to the creation of an independent Slovak Republic

If a referendum had been held, individuals with different positions on the role of the state would have voted as follows in *Table 1*.

Table 1

Ideas concerning the role of the state and attitudes to the division of the ČSFR

	for the division percent	against the division percent
liberal-conservative orientation	42	49
social market orientation	29	51
socialist orientation	29	50
total population	29	50

As the table shows, the group having a liberal-conservative orientation is subdivided into two subgroups of approximately the same size: advocates of state independence for the Slovak Republic and liberals who, right up to the division of the ČSFR, had pro-federalist positions. The proportion of SR state sovereignty advocates decreased as a function of the opposite—i.e. socialist—orientation.

Contrasting attitudes to the division of the ČSFR were also reflected in different feelings over the division of the country: positive feelings over the division of the country are found more often among individuals of a liberal-conservative orientation than among those of a social-market or socialist orientation.

Table 2

Ideas concerning the role of the state and feelings about the division of the ČSFR

	fear percent	new opportunities percent
liberal-conservative orientation	36	60
social market orientation	56	40
socialist orientation	70	45
total population	60	40

Ideas concerning the role of the state and political self-categorization

The categories comprising rightist, leftist and centrist political orientations respectively are not clearly defined in Slovakia. The majority of people claim to be in the middle, between the left-wing and the right-wing orientation. In theory, the socialist orientation should lean towards a leftist political orientation and, conversely, one would expect liberal and conservative orientations to reject the key role of the state, in line with a right-wing political orientation. However, as *Table 3* suggests, in Slovakia it is impossible to speak about a clear-cut connection between value orientations and political self-categorization on the left-right continuum. Yet there certainly is a tendency to stronger right-wing orientation and weaker left-wing orientation as a function of the declining stress on the role of the state.

Table 3

Opinions concerning the role of the state and political self-categorization

	left-wing percent	centre percent	right-wing percent
liberal-conservative orientation	7	34	38
social market orientation	17	40	21
socialist orientation	25	43	11
total population	19	41	18

The proponents of a liberal-conservative orientation have an above-average representation (three times as high as the average for the population as a whole) among those individuals who are personally involved in the process of privatization; they have their own firms or are private sector or joint-stock company employees, in contrast to social-market oriented or socialist-oriented individuals, most of whom report to be public sector employees. Liberal-conservative oriented individuals exert considerable political efforts to gain representation in the parliament or the government in order to assert their economic interests.

This differentiation was also reflected in the electoral preferences demonstrated in the June 1992 elections, when 17 percent of the adherents of a liberal-conservative orientation gave their votes to the Civic Democratic Union (ODÚ), the Democratic Party (DS) and the Civic Democratic Party in Slovakia (ODSS)—i.e. parties that did not obtain any seats in parliament. According to the electoral preferences recorded in March 1993, the parties on the right pole of the political spectrum (the Entrepreneurs and Small Business Party, the Democratic Party, the Party of Conservative Democrats, the Hungarian Civic Party) would have obtained most of their votes from this very group of liberal-conservative individuals. Thus the Entrepreneurs and Small Business Party that was established as late as Febru-

ary 1993, (i.e. one month before the survey was conducted) would have obtained 54 percent of votes from liberal-conservative individuals, in contrast to only 7 percent from social-market oriented individuals and 39 percent from those of a socialist orientation. The Party of Conservative Democrats would have obtained 63 percent of votes from liberal conservative individuals, 38 percent from socialist oriented individuals and no votes from individuals with a social-market orientation.

Ideas concerning the role of the state and values of democracy

A liberal-conservative orientation is found more frequently among those individuals whose standard of living has gone up; it is, therefore, primarily that layer of the society that has profited from the change in ownership status and on-going economic reform.

Table 4

Ideas concerning the role of the state and evaluation of the current regime in comparison with the pre-1989 regime

	it has more advantages percent	it is the same percent	it has more disadvantages percent
liberal-conservative orientation	69	9	20
social market orientation	39	18	38
socialist orientation	21	17	60
total population	34	17	46

Table 5

Ideas concerning the role of the state and political value preferences

	national unity percent	both principles percent	plurality democracy percent
liberal-conservative orientation	16	36	48
social market orientation	37	27	36
socialist orientation	48	26	25
total population	40	28	32

This category is characterized by the prevalence of positive judgments on the current system, in comparison with those before 1989. The opposite pole in the evaluation of the standard of living and the character of the current system, in comparison with the pre-November one, is occupied by the adherents of a socialist orientation.

There is also an interconnection between a liberal-conservative orientation and emphasis on the values of freedom and pluralism. Socialist oriented individuals prefer law and order to freedom and democracy, as well as unity and cohesiveness as opposed to pluralism of opinion and democracy.

Attitudes to social policy

The emphasis on the role of the state is also projected into the area of social policy.

Respondents believe that the state should play an important role, especially in the area of health care. According to 80 percent of respondents it should guarantee a better quality of health care.

The distribution of opinions concerning the financing of education is, however, different: 46 percent of respondents agree and 50 percent disagree with the opinion that if parents want their children to receive a better education at private elementary or secondary schools, they should finance it themselves.

47 percent of respondents agree and 47 percent disagree with the opinion that people should only have as many children as they are able to bring up, without financial assistance from the state.

On the whole, inclinations to three basic social policy models can be identified: the institutional redistributive model, the corporatist model and the liberal-conservative model.

These three social policy positions were identified by the negative or affirmative replies of respondents to the following five statements (the latter, according to the reliability test, measure the common social policy concept):

1. "If parents want their children to receive a better quality education at private elementary or secondary schools, they should pay for it themselves".

2. "Unemployment benefit should be low enough to motivate the unemployed to search for a job".

3. "People should only have as many children as they can bring up themselves".

4. "If people want better health care, they should pay for it".

5. "If people do not have enough money to afford the rent or buy an apartment, they should move to a cheaper place".

The institutional redistributive model of welfare involves a universal, state-financed social policy. This type of strong social policy was expected by 40 percent of respondents, who expressed their agreement with a maximum of one of the above statements.

At the opposite end of the scale there is the liberal-conservative, residual type of social policy in which the main actors are the individual, the family and private agencies. This type of social policy aims specifically at those members of society who are in a threatened situation, unable to take care of themselves. The propensity for the residual model of social policy was found among 18 percent of the respondents; they expressed their agreement with at least four of the five possible statements on social policy.

The corporatist model of social policy has a pluralist character; in addition to the state its actors also include the employers. This is a model in which the state, individuals, the family and social agencies all play their role in social policy. This model was supported by 42 percent of the respondents, who expressed their agreement with two or three of the above statements.

Social policy in pre-war Czechoslovakia was constructed on the basis of a corporatist model. That model was modified by the communist system. It can be characterized as a mix of the universalist elements of the redistributive and corporatist models. However, it appears as a much poorer variety when compared with the level of these models in Germany. The residual forms do not have a strong tradition in Slovakia. Experience with the existing social policy system is also reflected in the present-day preferences of the population for the redistributive and corporatist welfare models.

The preference for a particular social policy model is interrelated with ideas concerning the role of state. Individuals who support the redistributive model include 46 percent of those of a socialist orientation, 39 percent who are of a social market orientation, and 23 percent of those of a liberal-conservative orientation.

In contrast to 90 percent of individuals of a socialist orientation and 79 percent of individuals of a social market orientation who stress the combination of redistributive and corporatist models, 79 percent of individuals of a liberal-conservative orientation prefer a combination of corporatist and residual models.

Preferences for particular social policy models are also related to the economic expectations of respondents: 90 percent of "catastrophists" were in favour of a redistributive or corporatist social policy model, as against 83 percent of "illusionists" who prefer a corporatist or residual model. It can thus be stated that a higher degree of criticism or pessimism in the evaluation of the economic situation corresponds to expectations of a stronger role for the state in social policy.

Entrepreneurs—a new social class

In the space of two years economic reform has changed the social structure of Slovakia. Now, less than a half of the economically active population are employed in the formerly predominant public sector; 15 percent are private sector owners or employees and 10 percent are employees of joint-stock companies.

Private entrepreneurs are becoming a real economic force and this is attested by the fact that the private sector created, during the first nine months of 1992, 10 percent of national income and accounted for 17 percent of employment. At the same time, the entrepreneurs have become a real political force and a powerful interest group. This has been demonstrated especially by successful protest actions organized by the Association of Entrepreneurs of Slovakia. Under the pressure of entrepreneurs' activities the National Council of the Slovak Republic adopted, three months after passing the act on the National Insurance Company, the so-called "small-scale amendment" to this act. The amendment was in full compliance with the demands of the Association of Entrepreneurs of Slovakia, and promised to adopt a "large-scale" amendment of this act because its original version presented a danger of liquidation of small and medium-sized businesses.

The protests of entrepreneurs and their employees enjoy the support and solidarity of the population: 63 percent of respondents consider entrepreneurs' protests against government decisions to be justified, in contrast to 23 percent of those who disapprove of them.

Compared with other social groups the entrepreneurs and their employees are more positive in their assessment of the post-November regime. This also reflects their above-average favourable evaluation of their standard of living in comparison with other members of society.

Table 6

The assessment of the current regime compared with that before 1989 among employees in different ownership sectors

	The present regime		
	has more advantages percent	is the same percent	has more disadvantages percent
private companies	51	16	31
joint-stock companies	39	14	41
state-owned companies	33	16	48
cooperative companies	25	20	48

The economic expectations of employees in different ownership sectors do not markedly differ from one another. Two thirds of entrepreneurs and their employees have negative economic expectations (34 percent of "catastrophists" and 29 percent of "pessimists", as against 17 percent of "optimists" and 9 percent of "illusionists"; these figures can be compared with the above distribution among the population as a whole, which represent 36 percent and 33 percent as against 14 percent and 5 percent, respectively). In other words, they are just as critical of the current economic policy of the government as the rest of the population.

The concept of a social market economy has its adherents among 50 percent of entrepreneurs and their employees; 30 percent of socialist orientation, and 20 percent are of a liberal-conservative these show a marked orientation. In spite of certain shifts in the evaluation of the role of the state among private sector representatives, there is a prevailing orientation to the strong role for the state both in the economy and social policy. The dominant preferences are for the redistributive and the corporatist welfare models.

Bratislava, October 1993

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OBITUARIES

In memoriam: Tamás Nagy

Tamás Nagy, Professor of Political Economy, has died at the age of 80. He was very highly respected, and in a way that only very few people of his discipline have been. However, this respect was paid to him not simply because of his rank or position.

From 1948 on Nagy was a curator of the Karl Marx University of Economics in Budapest, as well as professor and head of the Department of Political Economy. In 1953 he gave his support to the economic policy outlined in the programme of Imre Nagy, and propagated it in his lectures. In 1954 he was appointed head of department of the Institute of Economics of the Hungarian Academy of Sciences, where, together with his staff, he took a critical look at the anomalies, and grave and incipent contradictions of the system of central planning. He was instrumental in enabling the Institute to become a workshop for reform ideas. During the October 1956 revolution he became a member of the Revolutionary Committee of Intellectuals. In the mid-1960s, when the party decided to launch a reform of the economic management, he sat on a committee that was commissioned to harmonize preparation work and to formulate proposals. Much of his energies were spent on fending off attacks on the reform and on helping to improve ongoing reforms. He contributed to the famous study "Change and reform", which stated that no fundamental economic reform would be possible without political reform, and no political reform would be possible without political pluralism. He remained active to the last, closely following events in politics and the economy, and showing a keen interest in new scientific problems.

Tamás Nagy was able to accept and absorb from all intellectual trends and schools anything he held true. He said: "What we have here in the wake of a socio-politico-economical development called 'socialism' is a given thing. Let's see how we can get from here, in the quickest way and with the least possible sacrifices and conflicts, to a democratic, humane and economically efficient society." This is how he accepted the notion of a mixed market economy dominated by private property wherever reasonable; this is how he got the idea of collective owners independent of the government: pensions offices, insurance companies that might have shares in state-owned enterprises, the concept of co-operatives based on voluntary personnel and financial partnership, and to state planning and investment responsible for the development of infrastructure and environmental protection. It was his firm belief that these could not be implemented without a radical reform of the political structure, involving abolition of the nomenclatura system, and the introduction

of political pluralism (i.e. a multi-party system). He had the sort of social and economic establishment in mind that already exists in Western welfare states like Sweden.

Tamás Nagy's strength was in the spoken word and perhaps even more his gift to quickly grasp the essence of, albeit sometimes vague, argumentations and to make a whole of the parts. His ability to synthetize was unrivalled and this is why people liked to be led by him.

During his active life, he was often attacked for his political, theoretical and scientific views. He died a lonely man; in the last years of his life the only contact he had with the outside world was the Institute of Economics. He felt that his life had been useless. This was, in my view, his biggest mistake. His one-time students and colleagues always held him in the highest esteem, and they will surely hold his memory in an equal degree of honour and respect. We know that his contribution to the preparation and development of the 1968 economic reform, that still has an effect on our world, was of great value. In fact, his name is inseparable from the reform. I had the luck to have close contact with him from my graduation until his death. I will always miss him.

T. ERDŐS

Róbert Hoch (1926–1993)

Róbert Hoch was born in Budapest in 1926. He graduated at the University of Economics in 1950. While still an undergraduate, he taught at the university's Department of Political Economy, and later became assistant lecturer in that Department.

He was extremely popular among students because he was a born educator who always stood up for just causes and, in the case of conflicts, did not hesitate to fight for his students. This and his staunch pursuit of reforms from 1953 onwards resulted in confrontations with the university's leadership, and in February 1955 he stopped teaching and became a research fellow at the Institute of Economics of the Hungarian Academy of Sciences. There, he became an even more determined advocate of reforms and was instrumental in the Institute's turning into a stronghold of reform thinking and an ideological hotbed for the reform of economic management that was to come in 1968. The institute started to play this role in the mid-1960s and Róbert Hoch himself was one of the fathers of the 1968 economic reform.

In his scientific works he helped integrate valuable concepts and methods of market economy (like demand research or the calculation of the flexibility of incomes and prices, which had, until then, been rejected) into the thinking of economists.

His research into factors influencing the structure of consumption were of great importance. Of special significance was his criticism of views regarding indifferency surfaces. He grasped its rational core, the depiction of income levels, and built it into his consumption theory. Such scientific achievement was rooted in Hoch's nature. He refused to see things as absolutely perfect or absolutely wrong and sought faults in what seemed to be perfect and tried to find values in what was said to be unacceptable.

Hoch spent much of his energy dealing with questions of price theory and price planning; his contributions invariably drew attention in the recurrent debates on prices. His memory will long be kept alive by hundreds of his publications and books, several of which are available in foreign languages as well.

He passionately loved teaching and, even after he left the university, grasped all opportunities to do so.

At the Institute of Economics he headed the Department for Research into Living Standards and soon turned it into a lively creative workshop. This was made possible not only by his enormous knowledge but just as much by his lovable, jovial personality. Colleagues were not just colleagues—they were also admirers and friends. Hoch participated in the preparation of a concept for the long-term planning of living standards and in the 1980s he worked out a course that was different from the official economic policy of the time; his own plan stressed the importance of the development of domestic consumption and infrastructure. He called for a way out from the country's stagflationary state and suggested that the first task was to fight stagnation (by developing the domestic market and the infrastructure), then to reduce the rate of inflation.

In 1985 he became a corresponding member of the Hungarian Academy of Sciences and held his inaugural lecture on the openness of the economy. With regard to the quantitative and qualitative openness of the economy, his arguments are valid to this day. He was one of the first ones to declare that Hungary should join Europe and should aim to be close to the centre of its activities, rather than remaining on the periphery. In 1990 he was elected to be a full member of the Academy.

Róbert Hoch was an active member of the scientific community throughout his working life. For years, he had functioned as deputy manager of the Institute of Economics of the Hungarian Academy of Sciences. For over two decades he had been member, and for a while vice chairman, of the Committee for Economics of the Academy. He also sat on the Special Committee for Economics of the Academy's Accreditation Committee, and on the board of editors of *Acta Oeconomica* and *Társadalmi Szemle*.

He lived in an age when many people did not hesitate to make about-turns. Not him. In his youth he was often branded as a revisionist; as a man he fought for reforms and for a more human socialism. He stayed a leftist to the last ditch, a leftist who was always ready to fight for eternal left-wing values, but could just

as well reject what became dated or wrong, as well as renewing ideas while staying vintage himself. With the passing away of Róbert Hoch Hungarian science has lost a great personality and an outstanding educator.

A. SIPOS

Ferenc Molnár (1923–1994)

Ferenc Molnár has passed away. We are bereaved of a man of universal erudition, impressive talent and achievement in three disciplines. He was in the vanguard of the "great generation" of thinkers, who emerged in Hungary after 1945.

Having obtained a medical doctor's diploma, he engaged in medical research in 1945. In 1948 he left the medical profession and enrolled in the newly founded University of Economics in Budapest. "Why have you changed your course?" I asked him nearly two decades later. (I met him first in the mid-1960s.) He said he had recently read Marx's *Capital*. That work exerted such an influence on him that he decided to study political economy in detail.

To understand his decision, the reader is advised to consider that sweeping social changes occurred in Hungary following 1945. A man of unquenchable thirst for knowledge about the world, Molnár decided to study the underlying causes of social progress. Just like numerous other professional people at the time, he came to regard Marxism as the most sophisticated theoretical system to be used for that purpose.

"Why have you changed your course?" I was compelled to ask him once again nearly two decades later. In 1983, at the age of 60, Molnár, a theoretical economist of international renown, retired and quit the economist community. Only those close to him knew that he had changed careers: he became a historian. He started studying archives and libraries in Hungary and Vienna on his own initiative and at his own expense. The object of his research was the life and activities of Emperor Joseph II of Habsburg.

Ever since his student years—he explained to me—he had had the ambition to write a monograph about Joseph II, who did so much to modernize feudalism. That opportunity came during the early 1980s. His book was published in 1987.

In our era of increasing specialization, few have the chance voluntarily to cultivate several disciplines. Ferenc Molnár could do so because he had a classical European erudition, was proficient in several languages and had immense knowledge about various ages and disciplines. Each of his change-overs was voluntary. A man of sovereign personality, he insisted on selecting his themes of research even at times when independent thought was heresy.

Strictly speaking, his work as an economist spanned some three decades. He was on the staffs of several institutions: the National Bank of Hungary, the National Planning Office, the Secretariat of the United Nations in New York, and the Institute of Economic and Market Research in Budapest. However, the most fruitful period of his economist's achievement was associated with the Institute of Economics of the Hungarian Academy of Sciences—where his employment was interrupted by spells spent elsewhere. For me the most precious among his writings are those works and polemic articles he wrote during the 1960s.

Subjectivism or even preconception may blur my assessment because I am a contemporary observer of his life-work. As I cannot apply the method of hindsight, I have to confine myself to examining the impact of his works on the scholarly thought and public opinion of his time.

My analysis of the voluminous literary legacy of Ferenc Molnár shows that two of his writings exerted special influence on public opinion. One of them was his first monograph, published in Hungarian in 1963 and in English in 1970: *Economic growth and recession in the United States*. The other one was a polemic article. Its title was, true to the customs of the time, lacklustre: "Some theoretical problems of contemporary capitalism". (*Acta Oeconomica*, Vol. 1 (1966) Nos 3–4) Ferenc Molnár was on this journal's first editorial board and took an active part in advising the editor in the early years of its publication.

In both of the above mentioned writings he challenged tenets of the official ideology of the time by confronting them with hard facts of reality. The monograph is an analysis of the economic structure of the most advanced industrial country, the United States. Molnár deployed hard facts to explain why the United States had been able to avoid an economic crisis of the magnitude of that in 1929–30 following World War II (which by then even the official analysts had to admit) and why the United States was likely to ward off any such crisis in the future. Molnár was the first Hungarian economist to call attention to the fact that in the United States the relative proportion and absolute size of the productive industries were declining, while the service sector was becoming dominant. Applying a complex examination of a set of factors, he gave a detailed description of the changes in cycles of reproduction and of the related consequences. The thirty years that have passed since the writing of his book have borne out his conclusions.

In his polemic article—unlike in his book-size study—he launched a straightforward attack on the official ideology of the time. Applying the methods of Marxist economic theory, Molnár went as far as pointing out that the key tenets of Lenin's theory of imperialism were either erroneous at the outset or had since lost validity. Instead of sending a message about it between the lines, he declared without disguise (in the officially approved press of Hungary in 1966!) that it was untenable to describe the group of capitalist countries as the "imperialist system". As he put it: "wherever it [the inter-relationship of certain countries] is imperialistic, it is not a system, and wherever it is a system, it is not imperialistic".

Ferenc Molnár was not a politician and never aspired to become one. Official honours and office were not his ambition, and neither did he get them. He never bothered to collect "credits" in this or that fields (of which he tried his skills in many). "All" he did was to be an honest scholar and an erudite thinker devoted to humanist ideals. He made the most of life.

L. SZAMUELY

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BOOK REVIEWS

DONÁTH, F.: *A Márciusi Fronttól Monorig. Tanulmányok, vázlatok, emlékezések.* (From the March Front to Monor. Essays, sketches, memories.) Budapest: Institute of Economics, Hung. Acad. Sci.—Századvég Kiadó. 1992. 314 p.

If Ferenc *Donáth* were alive today he would now be eighty years old. His economic works or, to be more precise, his political works were much read by economists[1] and they were published during his lifetime. (Donáth 1969; 1977; 1979) A few dozens of his shorter and longer papers appeared in periodicals, and he published much more than would have been expected from a politician who called himself a "researcher in spite of himself". He was fond of, and talented in, writing. Several times in his life he was a journalist and the editor of some newspaper.

This presently published omnibus volume, although it appeared in a series entitled *Oeconomica Publica*, contains mainly his political works, among them even those which remained in a fragmentary form; practically everything in his literary work that had not been published is now made available; before now, such works were hardly accessible to the reader. The editors have also selected some writings which have only appeared recently, very likely in order to give a comprehensive political portrait of Ferenc Donáth. Donáth was, throughout his adult life, a politician. What is more, he was a politician of the rare type for when he discovered that some idea, dear to his heart and mind, had begun to germinate in some circles, instead of trying to monopolize it, he built up the connection among its inventors and helped to give birth to the movement, organization through which the idea could be realized. This was an unusual quality in a young man, especially when the young man called himself a communist. Yet, fifty years later, we would rather refer to him as a socialist.

It was not only because of the 7th Congress of the Comintern in 1935 and its famous resolution on the people's front that Donáth, with marvellous impartiality, visited the summer camp of the Soli Deo Gloria (a protestant youth association) to make friends with students. Nor was it a result of that resolution that he went to Makó in 1939 to join his friend Imre *Kovács* and his companions when they founded the National Peasant Party. They had no permission to hold this meeting, therefor it took place on a boat, cruising up and down the Maros river.

A man of such a mental constitution, even as a politician, does not devote himself particularly to writing; yet, the editors of the volume have found some works worth publishing from almost every period of Donáth's political activities. They are all of interest, and some are indeed excellent.

The editors have divided the manuscripts published here into five groups. Three of them are linked to significant periods of the author's political career: the first one dates from the late 1930s until the land reform in 1945; the next one goes up until 1956, and the third from 1956 until the oppositionist movements of the eighties.

The March Front

The first great period was linked to the March Front. This was the oppositionist movement which, in the second half of the 1930s, was able to encapsulate all the neglected, deliberately ignored and concealed problems of society in the Horthy era. This was done in such a way that the problems were immediately given up-to-date, democratic answers. All this was done so vividly and in such an easily intelligible form that it soon became, for a fairly wide and influential social strata, a convincing alternative to the dubious policy of the governments of Gömbös, Darányi and Imrédy.

The March Front was born in 1937 from the briefly worded but persuasive yearnings of

[1] The passages printed in italics are in all cases italicized by the quoted author. If no other source is marked, the page numbers occurring in the text are those of the reviewed volume.

Akadémiai Kiadó, Budapest

the populist writers who used to meet in the Café Central in Pest, and from the motivations of the leftist university students to take some kind of action. Donáth was one of those whose major role was to link up and keep together the two wings, and to draw up their programmes. Imre Kovács, who was almost the same age as Donáth and just as lively and agile, another who was involved in all this. About the Debrecen youths and their friend, Donáth, Kovács wrote: "... we were fully aware that they were communists... We did not intend to convince them". (*Kovács* 1992) He first met these Debrecen youths (Géza *Losonczi*, József *Szilágyi*, Sándor *Zöld*, who all met a tragic fate) in 1936 at the Debrecen Diet. The proclamation of the latter came to be the forerunner of the 12 points Kovács read out on March 15 1937 and, later on, of the Makó Proclamation.[2]

In the book three papers are published from this period—more precisely from the time when police persecution, rightward drifting political trends, and internal disputes were already impeding the March Front. The first of these papers, which are arranged in a chronological order, deals with the right of voting. It says that the new electoral law drafted at the end of 1937 by the Darányi government—in return for annulling the earlier open voting in the provinces and introducing the secret ballot—wished to reduce the number of enfranchised voters by prescribing a higher age limit, a longer period of residence, and a regular income. All this was aimed at reducing the number of leftist voters. (For the sake of objectivity I must remark that in the course of the 1939 elections a significant number of the voters who remained untouched by the new law gave their votes to the extreme right.) This article appeared in one of the last issues of the periodical *Válasz* (Reply), which ceased to appear in May 1938. The *Kelet Népe* (People of the East) was aimed at replacing *Válasz* and this is why Donáth published two of his articles from 1939 in *Kelet Népe*. Both articles were analyses of a typically Marxist type. The first one, bearing the then fashionable title of "Agrarian democracy", contains a remarkable historical explanation about how the distortion of Hungarian agrarian development had distracted the peasantry from the path of taking on bourgeois civilization. (Donáth had by then already read the first part of József *Révai*'s manuscript entitled "Marxism and populism". Révai rejected the not too precisely defined notion of "peasant democracy". The reader cannot avoid raising the question of whether or not Donáth's article was a commentary or a polemic treatise.)

The other article, entitled "Land reform and the industrial working class", may be considered as party-literature. Classes and social strata appear in it as personified participants of social processes. Nevertheless, this writing contains a lesson worth taking into consideration—namely, that the most important thing that the peasantry expects from a land reform is not merely a piece of land but a change in their whole lifestyle. The challenge that prompted the writing of the paper was the then latest land reform bill of the Teleki government. Donáth's aim was to win over the left-wing social democrats to the Leninist idea, according to which a radical land reform could never be expected from the bourgeoisie; only an alliance of the working class and peasantry could produce such a reform.[3]

Two other papers in the same section deal with the March Front itself. The first one was probably written in the seventies. It is a review of the movement's history. It was presumably written on request, for it is strongly centred on the International, being slightly noncommittal but highly objective. Contrary to the party history written up to then, Donáth lays down very definitely that the March Front, although it involved several young communists

[2] Imre Kovács was acquainted with Donáth from an earlier period. If somebody is interested in the text the two young politicians agreed upon (after lengthy debates and compromises) they can find it in *Borbándi* (1989).

[3] The paper contains, without giving any name or institution, a reference to the action programme of the National Youth Committee (formed within the social Democratic Party). This was led by the communist Gyula *Kulich* and the programme included the claim for a very radical land reform: however, the Social Democratic Party did not put it on the agenda of its 32nd Congress held early in 1939.

and some organizations and bodies led by them, was not and could not be controlled by communists. This paper also acquaints the reader with certain interesting details; for example, Péter *Veres*, who was in the Hungarian Social Democratic Party on sufferance, and Ferenc *Takács*, one of the recognized agrarian politicians of the party, frequented the Café Central, where the March Front had been organized. The paper also shows Donáth's subtlety, his familiarity with leading circles of the intelligentsia and probably his successes. It was these factors which gave him exceptional respect and earned him independence among Hungarian communist leaders living abroad at that time.

One more memory is given about this great period of Donáth's life; he had earlier recounted this in a college in Szeged, in 1983. The conversation which was then tape recorded gave a detailed account of the programme of the March Front. Donáth commented what the programme had to say about the relation between "human rights" and democracy, and the individual and the community. He also gave an interpretation of the concept "populist"; finally, he talked about his one-time friends, Ferenc *Erdei* and István *Bibó*. Concerning the question whether the March Front was a rudiment of the People's Front in Hungary, he left this for the party historians to decide. Instead, he emphasized the authenticity, the timeliness and the Hungarian character of the movement and its programme.

The war, the land reform and what followed after them

For Donáth in particular the years after 1939 were hard ones. Arrest, police surveillance, forced labour service, a serious disease and, finally, from 1942 on, the necessity to go underground. In the circumstances of underground existence Donáth was again very active: he was a member of the management of the Peace Party, and after that he was involved in the reorganization of the Communist Party, the Hungarian Front, and the underground newspaper *Szabad Nép*. It is hard to find some memoir or recollection by any left-wing author in which his figure does not crop up, either in a serious or in an anecdotal form. The most amiable of such authors is perhaps the artist, Piroska *Szántó*. She mentions Donáth in very affectionate terms in a book in honour of Bibó. (The scene she mentions is in a workshop which produces ceramic buttons in the Henger street in Pest): "We had an electric furnace", she writes, "but we retained the old wood-heated furnace too, for baking jugs: behind the big round belly of the furnace the Peace Party held its consultations... it was there that Gyuri Markos kept yelling with Feri Donáth..." (*Bibó*... 1991)

No manuscript of Donáth is left over from this period. It is very likely that none was written. In 1945 a short lull follows, with the daily of the Communist Party, *Szabad Nép*; then, from February, with the government in Debrecen and after this comes the next high point of his life, the land reform. At the beginning he worked on its preparation as the assistant of the then Cabinet member Imre *Nagy*. Later on, as agricultural secretary of state, he controlled the implementation of the reform.

In 1939 Donáth wrote about the land reform: "There is a rather thin stratum of peasantry which expects from the land reform a new basis of developing bourgeois civilization... For millions of peasants, however, without putting it into words, only in the depth of their souls, it means something much more comprehensive. Namely, the rearrangement of the whole of peasant life, the substitution for a way of life which has come to a crisis, by something brand new, which can hardly be described by them..." (p. 42).

In reality, what could the land reform give? From 2.7 million hectares of land—this comprised almost the totality of non-peasant land—1.8 million hectares were distributed among 640 thousand people. Of these, one hundred thousand were agricultural servants, while the rest of them were landless agrarian labourers or peasants with very small pieces of land. Less than 3 hectares was awarded to each household. Hence, as a result of the land reform, nobody came to be owner of a viable property. Yet where the property structure and, linked to it, the social and power mechanism based on feudal ownership had survived until the twentieth century, there was no other choice. Together

with the lag in industrial development, the distressing problem of agrarian overpopulation immediately came to the surface.

The collection contains two articles from this period, and both appeared in 1946 in the *Társadalmi Szemle* (*Social Survey*). A member of the Central Committee wrote them. Had there not been statistical tables in it, the first one might even have made a good paper for the contemporary *Szabad Nép*. The second one—entitled "Which way is the Hungarian village going? The capitalist development of agriculture"—was influenced by domestic party jargon and to a certain extent by the Soviet style. Donáth noticed that from such agrarian relations not even capitalism could find a way out. At the same time his advice about class warfare and farmers' cooperatives marked out a path for the peasantry which ultimately led them to defencelessness.

The decay is obvious and the course of his life took a downward turn. From 1948 onwards Donáth led the secretariat of the Central Committee; in effect, this soon became the secretariat of *Rákosi*. In 1949 he entered into an unfortunate controversy with Imre Nagy. Arrested in 1951, in the framework of the *Kádár* trial, he was sent to prison. Released in 1954, he was one of the few who received full rehabilitation, but he was reluctant to participate again in political life.

The time of the revolution

As Miklós *Vásárhelyi* remembers, Donáth began to be active again in the environment of the Petőfi Club. (*Tóbiás* 1989) It was a slow, painful process. Presiding at the first debate of the Petőfi Club—which was on economics and eventually had a far-reaching effect—he only added a few words, and even these comments were no more than corrections of some blatant professional errors. Their political content is at the most that if one in the process of collectivization has violated the Leninist norms must not be surprised that agriculture has not begun to flourish. However, the short-hand minutes of the meeting show that Donáth made a fairly unexpected and extremely impetuous sentence. It had no antecedent and was not followed up. He said: "The agricultural producing cooperatives which were brought into being violently and with terror, are unworthy of being called socialist large-scale farms." (*Hegedűs and Rainer* 1989) At that time it was not yet customary to use such words.

He delivered a lecture on the situation of Hungarian agriculture in Debrecen on October 22 1956, and this is published in the book. It is characterized by the duality of Donáth recovering his wits but at the same time maintaining reticence. Here questions of national significance are touched upon: "If we remove the chains of forced production from the Hungarian peasant and land, and bring into motion and give free way to the skill, the knowledge and love of land, the ingenuity and innovation which characterize our peasantry, Hungarian agriculture may, within a short time, attain significant achievements" (p. 94). Donáth here returns to his former idea that farmers' cooperatives might serve as the basis for a real rural federation, but at that time not serving any more as the wooden horse of Troy for the kolkhoz system as it was the case in his article in 1946; instead of this, Donáth believed that the cooperatives should be transformed from their role as a covert monopoly for state procurement of farm produce, into real selling cooperatives. It is here that the idea of self-government appears in his writing, and he tries to give meaning to the concept of socialist democracy. This concept had already appeared in the July resolution of the Hungarian Working People's Party, but was only presented as a totally empty slogan.

On the night of the uprising the Central Board of the Hungarian Working People's Party co-opted Donáth and the ex-convict G. Losonczy—in their absence—onto the Central Board. Donáth was elected as a member of the secretariat and Losonczy as a substitute member of the Political Committee. The book contains their common letter of resignation, these having been formulated by Donáth and written on the morning of October 24. There is also a summary of a speech he made which was recorded in the minutes of October 26. In the former they request that the party should publicly give up the policy which had ostensibly caused the upris-

ing, and should get rid of its most compromised leaders. They also suggested that politicians most likely to represent comprehensive national collaboration should be invited into the government. The speech urged that the justification for the uprising be acknowledged, and that the rebels' claims should be accepted. The two politicians insisted on their standpoint up to October 28, when it was accepted by Imre Nagy and the majority. The text of the letter contains a very precise list of the Hungarian nation's grievances: insensitivity and lack of concern for national feeling (such as the removal of national symbols), ignoring problems of Hungarians living beyond the national borders, the anomalies of the Hungarian-Soviet relationship, slavish imitation of the Soviet Union, and the contemptuous treatment of the traditions and spirit of the Hungarian people.

The book contains some fifty pages of documents and memories (including the speech and the letter) from and on 1956. From these, the reader's attention should be called to the diary-like report about the first six days of the revolution. This was written while in captivity in Snagov, but is still rather "fresh", having been produced in December 1956. It is a very objective representation, produced in a plain style, of the atmosphere and mood of those days. It is the report of a man who is not frightened of the revolution but watches the reflexes of the crowd with natural empathy and does not feel himself an alien even amidst the multitude on the street.

He was then accused of the second order at the trial of Imre Nagy. To the subsequent history of the trial belongs a letter written by him in 1978, and this can also be read in the book. In this letter he protests, among other things, about the fact that some Hungarian emigrants, due to a lack of reliable sources but also sometimes for political reasons, accept the lies of the so-called "White book" about the proceedings of the trial. The letter is addressed to Miklós *Molnár*, a historian living in Geneva. He was at one time the editor responsible for *Irodalmi Újság* and a follower of Imre Nagy. Thus Donáth could count on his friendly benevolence. The letter contains several, until then unknown facts and data of the trial and of the events which were the subjects of the trial. It also mentions the time Donáth spent in Soviet and, later on, in Romanian custody. The then underground periodical *Beszélő* published the letter, along with its outcomes in 1982 and 1983. However, it had no consequential effect on hitherto accepted interpretation.

The so-called "Snagov notes" are also worth mentioning. The first one of them includes a draft entitled "The possibility of a way out (Draft)". According to the editors this probably dates from the early days of 1957 and is quite an interesting piece of the favourite literary genre which was typical of the period that followed the suppression of the revolution. It differs in many important points from the contemporary suggestions of Bibó; however, the writings of both Donáth and Bibó contain the claim for national sovereignty, as well as a government that expresses wide national solidarity, further they contain the concept of combining democracy with some form of a socialist order and the integration of people's bodies brought into being by the revolution (i.e. workers' councils, and revolutionary and national committees) into the political power. The following fragment can be considered as having key-importance from the aspect of Donáth's future work: "What organizations of state administration were brought about and how were they established by the uprising. What was their relationship to and conduct towards the old bodies of state management (local councils etc.)?" (p. 126). A direct outcome of this was his series of studies on the formation he called "direct democracy". Certain pieces from the latter—as well as his papers on agrarian economy—can found in parts III and IV of the book, arranged according to the date they were completed.

Agrarian essays

An interesting series of writings on agrarian problems appeared in the 1970s. Of these, the one entitled "Tulajdon és hatékonyság" (Ownership and efficiency) need not be introduced. Its first version was published in 1979, as No. 144 of the *Publications of the Research Institute of Cooperatives*. In professional circles it raised great interest because of its ob-

jective views, simple method and vivid style. The author successfully ordered and grouped well-known statistical data so as to create a fairly convincing picture of the large-scale—and continuously growing—agricultural production plants. According to him their main feature is that they could be controlled by the central state bureaucracy and, whether state farms or farmers' cooperatives, those working on them have the status of a wage-worker and can have no influence on questions of management. The reader can find in the volume a concise version of the original which appeared in the periodical *Medvetánc* and, though it may have lost some of its original freshness, it expounds in a more concise manner the problem which mostly engaged Donáth's attention. This problem was whether in Hungarian agriculture "separating the objective conditions of production from the producer" could be justified (in the given period) using the argument for efficient modernization.

Another paper, "A mezőgazdaság gyors strukturális átalakításának problémái és eredményei Magyarországon (1949–1970)" (The problems and results of agriculture's rapid restructuring in Hungary [1949–1970]) must have been written in 1971–72. Donáth presumably intended it to be the summary of articles that had been written by him already about agrarian history, and had been published in various periodicals. Another fragment accompanies it: "Társadalmunk titkaiból—A kollektivizálás fő folyamatai" (From the secrets of our society—the main processes of collectivization). As so often the case with Donáth, this is also a work that bears on it the main trends of the era; it contains, however, two particularly profound remarks, and it is worthwhile for the reader to ponder over these. One of them is that collectivization, both before and after 1956, afflicted the peasantry unbearably because, in addition to the well-known reasons, it once and for all deprived the peasants of the prospect of social progress. Afterwards, when the state legalized family cultivation in the cooperatives after 1965–67, improved the conditions of household plots, and introduced guaranteed wages and social insurance, it placed these within the framework of a different cultural way of living. The latter involved durable consumer goods, higher ambitions on the part of the peasant families, who wanted better schooling for their children, and were ready to make significant sacrifices to achieve these aims: "*...these became the driving force behind large-scale farming*" (p. 196). Today we would say that it opened up, by and large, the possibility for the same ill-matched bourgeois civilization which had been opened up to the more consolidated strata of town workers and low-wage employees. The other remark refers to the leading stratum of the large-scale cooperatives. It talks about their "*...new social power*, which had become *the main representative of large-scale farming* in opposition to the administrative bodies, industrial and trading companies, as well as peasants farming in collectives" (p. 198). The reason why Donáth in other passages of this treatise is so tolerant towards the producing cooperatives as forms of large-scale plants, and why he sees it as important to list all data connected with them that show their successes, is rather significant: after 1967, and up until the mid-1970s, he believed that out of the Hungarian agricultural cooperatives the self-governing form based on collective peasant ownership could develop something similar to what he discovered in November–December 1956 in the workers' councils. The latter had behaved (though they were power bodies) like proprietors of their firm or factory. This attitude of him came to light from a lecture which Donáth delivered in 1980, at a debate organized by Tibor *Liska*. It struck him that from 1967–68 to about 1972 the inner life of the cooperatives began to be vivid. Donáth says that "loud, crowded assemblies took place" (p. 208). The members began to request the leaders to become accountable, they intervened in the leaders' plans, and in questions of labour organization and division. However, after 1975, and a change of generation, precisely defined wage tariffs (similar to those of the state-owned enterprises), central ruling, the substitution of deputies' meetings for assemblies, and open voting for secret polls, forced amalgamation of cooperatives,—all these put an end to the rudiments of proprietors' democracy. The new managers served the interests of the party and the state (this was called the "national economic interest") and asserted their own in-

terests (this was referred to as sectoral policy).

In the midst of new movements

From this time on Donáth became extremely sceptical regarding any kind of economic reform. In this respect his behaviour was different from both that of the intelligentsia within the party, and from that of the one-time Marxist intellectuals who remained outside the party. In his opinion the system of economic institutions was not only irrational but at the same time almost a closed one (or, if certain parts of it were open, they could at any time, become closed), because the system was based on a concentration of power and property placing instruments in the hands of the state such that could be used in a totalitarian way. Donáth put forward this view not only at the debate organized by Liska, but five years later, in his brief contribution delivered at the Monor conference of the then oppositionist and reformist groups of intellectuals; it appears in his introductory note and in the postscript to the edition of the stenographic minutes.

The 1985 conference at Monor was organized by Donáth. It was the last time in his life that he convened a meeting that draw together those who, without him, might not have done so. For the sake of evocation, lectures were held by István *Csurka*, Sándor *Csoóri*, Tamás *Bauer*, and János *Kis*; invited speakers and opponents were (in the order of the lectures) Miklós *Szabó*, János *Kenedi*, Mihály *Laki* and Miklós *Vásárhelyi*. After those mentioned above, forty-five other participants continued the discussion. Donáth himself spoke very little. He let the others speak. As had probably been expected, at Monor not a single word was uttered about what had engaged Donáth's attention three decades earlier: namely, the question of direct democracy.

The following conference had already been planned at an earlier date. Donáth also organized this to take place at Monor. It would have been held in 1986, on the thirtieth anniversary of the revolution. However, he did not live to see this day. János Kis, the editor of the underground ("samisdat") publication, added a few-pages-long fragment by Donáth to the minutes of the illegally held conference on 1956. This appears in the volume under the title: "Töredékek az 1956-os forradalomról" (Fragments on the 1956 revolution). The most elaborate fragment deals with the Hungarian-Soviet relationship; the next one looks at questions concerning property; and the third is about the actuality of the revolution's solutions. "What was original in 1956, was the combination of the system of councils with representational democracy" (p. 136). At the very successful conference there were two who quoted Donáth's writing: Sándor *Rácz*, the one-time president of the Great Budapest Workers' Council, in his contribution and Imre *Mécs*, in his lecture entitled "Alulról jövő és spontán mozgalmak a forradalomban" (Movements in the revolution coming spontaneously from below). (*Hegedűs* 1992)

The essays on direct democracy

Donáth classified the bodies of people's self-government as institutions of direct democracy. He believed that these, in the modern era, in the course of revolutions in other countries, and in the present century in Hungary, had appeared in the spontaneous form of mass-movements whenever—owing to revolutions or wars—a gap had come about either in state administration or in the management of companies. In his opinion the 1918 councils, the national committees of 1945, the land claim committees working in 1945–46, and, along with these, the workers' councils, revolutionary committees and national committees formed in 1956, all belonged to this category. He considered their common features to be their corporate body-character, their democratic origins (their members were elected and re-elected under revolutionary circumstances), and their claim to exercise certain functions of public or administrative (perhaps proprietary) power. They were also similar in that they had an inclination to form common representations (limited by strict mandates) and to collaborate with other bodies of the same kind. The final point Donáth makes

is that none of them were organized on the basis of certain parties. What is more, they strived to achieve a kind of complementary role in opposition to the structures defined by the political parties. In these phenomena Donáth saw the prospect of some kind of democratic socialism; the latter was contrary to the alienated state and did not strive for totalitarian power.

In the volume three writings deal with the question of direct democracy in this sense. The first one originates from the early sixties and was to be a chapter in his—earlier mentioned—book on the land reform of 1945–1946. It was practically an attempt at summarizing all that he had outlined in preceding chapters about the activities of the national committees and land claim committees. The attempt was successful, for it presents in great detail and gives reasons why the national committees failed. Donáth believed it was due to the fact that the parties at that time (i.e. all of that were part of the coalition) and the government itself were aiming to restore the iron grip of the earlier centralized management. However, the creation of a theoretical foundation failed: in other words, the author, with a turn which cannot be fully followed, became enmeshed in the problems of substantive and formal democracy's contradictions. Donáth, albeit without real justification, tried to settle them in the framework of some conception attributed to Leninism and Stalinism. The second opportunity came to pass for Donáth a few years later when the first part of the manuscript of his book on land reform was discussed by a selected group consisting mainly of party historians. Donáth's answer—which was presumably prepared or subsequently compiled in written form—can be found in the book. It can be seen from this answer that the participants in the debate chose the method of respectful admonition, without seeing too clearly the facts and the data. (Let it be said in their excuse that the domain in question was not one which had been researched to any great extent.) However, the reader can still appreciate, even after so many years, the elegance of Donáth's answers. For instance, he illustrates the desirable relation between direct and representational democracy by using the regulation of the relationship between the congregation and the council drawn up in the Calvinistic constitution, voted for in Geneva. It is also here that Donáth expounds his opinion on representational democracy and he mentions the trends that have grown out from Marxism. This was in late 1967, a few months before the students' revolt in Paris, which also wanted democracy to be free of its manipulated and alienated character.

The third essay was written later, after more than a decade; it was written for the memorial volume honouring István Bibó. Donáth was invited to be the president of its board of editors. Even its title is significant: "Bibó István és a magyar demokrácia alapkérdése" (István Bibó and the basic question of Hungarian democracy).—It is one of the best essays of the two-volume memorial book.

The appointment of Donáth was a perfect choice. Bibó and Donáth had known each other since the mid-thirties; in 1937 they formulated together (at Makó) the Proclamation of the March Front. They worked in neighbouring offices in 1945 in Debrecen, and in 1959 made friends with one another in cell No. 52 on the second floor of the prison at Vác, where Bibó was the only non-communist prisoner. This friendship lasted until Bibó's death. Donáth's selection of the subject matter was also perfect. In the memorial volume honouring Bibó the contributors wrote about the theme that was most important to them at that time. Donáth was then, and had been for a long time, considering the possibilities for democracy in Hungary; that had also probably been the most important political theme of Bibó's life work. In this treatise the major starting point for Donáth was 1945, which was seen as a time for mental liberation, and of the democratic practice of people's self-government. 1945 had also been Bibó's starting point. With Donáth it was "the direct practice of public power". This had been maturing for centuries, but had time and again been miscarried. Both of them (and, in addition, Ferenc *Erdei*) considered that if the national committees worked in accordance with some regularly ordered legal principles, they could be the organs of real people's self-government. They blamed the Communist Party as well as the Smallholders' Party for destroying the committees and generally blocking their democratic de-

velopment. However, on getting acquainted with the party documents that had been signed in 1944 in Moscow, Donáth gave more serious condemnation to the cynicism of the party of which at one time he had been a member.

"The people's claim to exercise public power", wrote Donáth, "was, *in its content, greater and of a different nature in 1956 than it had been in 1945...*" "After November 4 1956 the workers' councils started their claim for participation in deciding on the basically significant issues of society and of the country... and for controlling the bodies of state power..." He pointed out that "... in parallel with the creation of new organs of people's power, *they commence the transformation of the production and ownership relations which constitute the basis of any system*" (pp. 241–242). Donáth, as well as Bill *Lomax* in his book published in 1976 (Hungarian edition 1989) and István *Kemény* in his paper of 1986 (Kemény 1991) strongly emphasize that the workers' councils and the regional or institutional revolutionary committees did not come into being because of the initiative of some party or some group of intellectuals. Although the councils and committees claimed that they accepted a multi-party system, they wished to build upon a foundation of common solidarity which would be independent of political parties.

Today's reader may be surprised that, at that time, Donáth still thought that Bibó's writings of 1956–57 do not mention the claim for self-government on local level, nor the need to extend "beyond the frameworks of the local level" (p. 235). Yet, in fact almost all of them do! Such claims can be found in the Draft of November 6 (Draft of a compromise for settling the Hungarian question), as well as in the Declaration dated December 8 (Declaration on the principles of Hungary's state, social and economic order and on the unfolding of a political solution). The extent to which this problem engaged Bibó's attention is verified by two analyses left over in fragmentary form. These appear in the fourth volume of his *Selected essays* under the titles "On the relationship of the parties and revolutionary organizations" and "The workers' councils and the multi-party system". The Draft which was forwarded to the Central Workers' Council of Great Budapest—under the heading: "5. *Alkotmányjogi megoldás*" (The solution by constitutional law)—contains the following: "Before holding general elections, out of the workers' councils and revolutionary committees a revolutionary constituent assembly shall come together..." (Bibó 1990)

The draft written by Donáth in Snagov, which has already been mentioned above ("The possibilities of the way out"), says the following: "The government ought to rely on the workers' councils, the revolutionary committees and the bodies that are expected to come into being to represent the interests of peasants". It also says: "A national top-corporation, comprehending the movement of these organizations, which would be a broader community of public authority (including a greater number of members) would temporarily replace the national assembly" (p. 120). Comparing the two men's writings, we must say that though the differences between their views are obvious, they could have agreed.

What is still left

The last few papers of the volume are, in a certain sense, reverential writings about colleagues and comrades in misfortune. This is why an article of 1971 reviewing the last book of Ferenc Erdei to appear in his life-time, being that also the year of Erdei's death, has been put in here. From the rest of these papers there is one dedicated to the memory of Péter *Veres*, entitled: "Nemzetségfő volt" (The man who was head of a generation). This is likely to touch the reader: it is a brief, affectionate and very respectful commemoration. The finely shaped portrait of Donáth's friend, Sándor *Haraszti* will inspire great sympathy; at the time it was written it could not be published, for it had strong words for the regime of Rákosi. The fragment analysing the tragedy of László *Rajk* draws attention to the special responsibility of Mihály *Farkas*.

An introductory essay to the volume entitled "Donáth Ferenc a magyar történelemben" (Ferenc Donáth in the history of Hungary) was written by János Kis. This writing is imbued with respect and affection and endeav-

ours to understand the dissenter, the man of another mind. Kis's biases or, sometimes, incomprehension, though formulated in political terms, are perhaps those of his generation, rather than being political differences. It is a great thing that he discovered how attractive the plebeian alignment radiating from most of Donáth's writing can be.

The editors of the volume, Judit *Szabó* and Tibor *Valuch*, have produced an extremely thorough work. Misinterpretations and clerical errors can hardly be found. It is a great help to the reader that the editors have attached a list of Donáth's publications (except those written by him as a journalist or editor, which were presumably not always marked by his name), as well as the biographical particulars compiled by Ferenc Donáth Jr. (Among these there is only one error or misprint which may be disturbing: Donáth was, together with the other members of the group of Imre Nagy, arrested by the Soviet army on the 22nd and not on the 23rd of November 1956.) If there is anything with which we can criticise the editors, it is the lack of footnotes for orienting the reader. For example, how can a university student today find out about those of Donáth's comrades who are marked only by their family names, and with whom Donáth debated in 1967? It might also have been useful to give the interpretation of references found in his earlier papers (e.g. references to draft bills of land reforms in the Horthy era etc.) The author of this review has made efforts to supplement details where possible. However, for someone wishing to write a thesis on Ferenc Donáth, it is better to look for such details personally.

The publisher, the technical editor, the designer of the cover and the printing house, all who collaborated in publishing the book, deserve special thanks and praise: this book is also aesthetically well-presented and it is a pleasure to take it in one's hand.

K. LÁNYI

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Someone who today wishes to condemn summarily the economic heritage of the preceding system will feel it is enough to point to the size of the foreign debt it left us and the generations who will follow us. According to another often emphasized opinion, indebtedness was the economic factor which enforced a certain economic discipline upon the political and economic leaders of the preceding system. In other words, they were striving to avoid both extremes of debt strategy and thus refrain from repayment of the debt and/or its refunding at any cost. As deterrent cases it is usual to refer to the Polish example and, as an instance of the latter, the Romanian experience.

The president of the National Bank of Hungary (NBH), in his foreword to the first essay under review, has written that the publication is aimed at acquainting public opinion with the history behind the foreign debt, the position of foreign indebtedness, and the future solutions. The experts of the NBH have not tried to avoid the incidental debates but to make them more meaningful by giving information about the facts. Oblath has definitely attempted to analyse the advantages and disadvantages of the strategic suggestions which have been put forward on behalf of politicians' and economists' over the last one or two years. With regard to this subject matter very few works have dealt with these issues on such a high level and been so rich in content as the above-mentioned ones. The questions are asked every day but they are still wrapped up with a certain secrecy—perhaps because for such a long a time only those officially authorized were allowed to make declarations to the public. The two publications in question were written for professionals; however, the significance of the debt and the importance of the discussions necessitates that they be given wider publicity.

The characteristics of the Hungarian debt

At the end of 1991 the Hungarian debt amounted to USD 22.7 billion. In other words, it amounted to 70 percent of the yearly income produced in Hungary and to more than double the year's exports. The interest and amortization to be paid were equal to 30 percent of the annual exports. In 1991–1992 the relative burdens of the debt markedly diminished, owing to the rapid growth of dollar exports. In the late 1980s and the early 1990s the financing of the debt was causing significant troubles, but today these troubles have greatly decreased.

Why did Hungary become indebted?

The authors of both works agree that, throughout the twenty years from 1970 to 1990, the debt came to be accumulated mainly due to the interest payments. They state that for the import of surplus goods valued at USD 1 billion Hungary paid interest amounting to USD 11 billion. This, indeed, was not good business! However, in this calculation it is presumed that for 1 dollar, say, in 1975, the same quantity of goods could be purchased in 1985; this means that the two amounts measured in dollars are treated as being equivalent. This distorting assumption modifies somewhat the proportions, but it remains basically true that considerable amounts of interest had to be paid. We must note, however, that if the loan is not amortized—i.e. the debt does not diminish—the interest payments, if we reckon with a fairly long repayment period, may amount to a very large sum. This is especially true if in the meantime the interest rates grow fairly high.

The authors state that in the 1970s Hungary still managed to import a substantial quantity of goods into the country; however, in the 1980s it became necessary to pay for these in the form of surplus exports and, in addition, the debt was constantly growing. Why was it nec-

essary to raise credits in the 1970s? The fact is that at that time money, owing to the suddenly increased export-incomes of the oil exporters, became extraordinarily cheap (the rate of interest was lower than even that of the inflation). The only countries which did not raise some credit and avoided such transactions did so due to ideological reasons. "Price rises will not ripple into the country", said the then economic political leaders. Also, the framework of the CMEA seemed to provide adequate protection, and the cheap capital was destined to cover the costs of further development. Eventually, it turned out that all this was an erratic calculation: the ideas of development were mistaken, and the profit expected from processing cheap Soviet raw materials was not realized. In addition, a new wave of price rises arrived and, beside all this, the until then cheap credits grew very expensive.

It is customary to say that the sources available were simply consumed and not invested. This is postulated by the study of the NBH. Analysing the period between 1979–1984 it states: "In this period of adjustment economic policy, though it could have diminished the imbalance between production and consumption of the income, was unable to drive the economy to cover the increasing interest burdens arising from the earlier involved resources" (p. 43). Today we know that the economic policy of the planned economy had only two alternatives: either to slow down, or to accelerate economic growth. The period 1973–1978 had shown precisely that the acceleration of economic growth or, more precisely, omitting the necessary slowdown due to the changed consitions, sharpened tensions. This situation led to a negative balance of trade and, as a consequence, to further indebtedness. (*Bauer* 1981; *Ungvárszki* 1989) Long-term interrelations can only be influenced by radically changing the institutional conditions. Nevertheless, current experiences prove that this is not so simple. Liberalizing prices, wages, foreign-trade contacts, and privatization are in themselves not enough for creating the conditions of economic growth.

"The development of the Hungarian terms of trade[4] was one of the *immediate eliciting causes* of indebtedness, and the failure of economic political adjustment to the changed environment of world economy aggravated the indebted position of the country", says the NBH paper on page 29. According to the data of table 6, between 1974 and 1989 the country suffered losses in terms of trade amounting to USD 9.7 billion and Rbl 12,7 billion. This formulation would mean that in the final analysis the changing terms of trade ought to be blamed for the indebtedness. Unfortunately, it is not as simple as this, for the cases of other countries getting into a similar position cannot be explained in this way. A system which for a long time pays no heed to foreign market prices and forces a growth greater than allowed by its potentialities becomes either indebted or creates a seriously distorted economic structure. In addition, the quoted calculation of the influence that foreign market prices had is misleading. One part of foreign trade prices is the result of economic activities pursued within the country. This is because, in the sphere of differential products, they come into being on the basis of individual bargains, and not as some unchangeable factor, as is the case with the exchange goods.

Another important element linked to indebtedness was the role of the CMEA. "Between the non-Rbl imports and the Rbl exports, regarding the whole period, there was a positive correlation. However, a reverse connection did not exist, except in the case of primary energy's convertible exports and Rbl imports of primary energy." (NBH p. 30). If this was partially true, such reference to a correlation is no proof, for the quantities linked in their changes to one another may have been very different. According to the train of thought to be found on pages 30–31 of the NBH's study, the Hungarian economy fulfilled a specific mediating function towards the Soviet Union; namely, some goods procurable only for dollars and necessary for the Soviet Union, became available to the Soviet Union by being built into Hungarian exports. This meant that while the losses of terms of trade in the rouble relation were compensated by exporting certain quantities of commodities, the increasing Rbl exports were one of the direct causes of the growing convertible imports. That is, these exports disturbed the convertible balance of trade.

[4] The ratio of the Hungarian export and import prices.

This is but one side of the connection. During the same period the energy imports from the Soviet Union came at prices lower than those on the world-market. At the same time, this form of economic relation seemed to be—at least in the short term—favourable from the aspect of both the state budget and the companies. As a matter of fact, this may have diminished the indebtedness; yet such an assertion implies that the economic structure is a given one.

According to another similarly summary finding: "*The sources involved were absorbed by consumption and non-efficient investments, without creating an effective production structure providing the possibility to repay the raised credits.*" (NBH, p. 51). At another place it is written: "The ratio between accumulation and consumption changed from 25:75 (which was typical of the 1970s) to 12:88 by 1983" (p. 42). "End-consumption in the years 1973–1984 declined only once. Thus, the primary objective of economic policy and the policy itself was—sometimes openly, sometimes in covert form—to increase consumption" (p. 57). This chain of thought, however, does not reflect the economic interconnections of the whole era. It is still not clear what quantity of resources was wasted in production proper. Nor is it easy to calculate the waste which occurred due to investment projects which were never put into operation. It is also impossible to assess the extent of consumption which was such only in name: i.e. using the pseudonym "communal consumption" it covered some part of the costs of national defence.

The management of debt

The cost of financing the Hungarian debt has been, on average, 9.31 percent. In the opinion of the NBH this cannot be deemed very high, even in international comparison, and especially if compared with other countries in a similar position and in need of foreign loans. Furthermore, the authors of the NBH study claim that over the last few years the average interest rate, though including a favourable decrease in extra interest charges, has exceeded that applied to countries qualified as the best debtors.

In the authors' calculation, if over the last 10 years dollar credits only had been raised, the net debt in 1990 would only have been USD 0.7 billion higher than the actual amount. This computation is aimed at proving that in the sphere of debt management the operations of the NBH were optimal, otherwise only a worse result could have been achieved.

"In order to gain an idea of what results are entailed by expressly reducing or eliminating the amount of the debt, it is enough to look at the present situation of the Romanian economy. Also, the consequences of the insolvency that has troubled the Polish economy from the eighties up to now can give a picture" (Oblath, p. 20). The two extremes really are deterrents, but is it true that no other way is available? Namely, is there anything that can come between the two extremes? There is (was) a country in the region which did not or could not choose indebtedness, and that is the former Czechoslovakia. It would perhaps be rewarding to take the principles of this example into account when considering the possibilities of analysis.

Criticism and answers

Oblath places criticism on official debt strategy into the following categories: emotional, political, global politico-economical, and economical.

According to the *economical* criticism, the West must not allow the extremely serious economic and political burdens on the young East European democracies to become even worse by additional burdens of debt service.

The *political* criticism claims that the credits were raised by the communist dictatorship for the sake of transitory stabilization of its power. The West, by extending the credits, practically supported and stabilized the communist regime. Therefore, it is not justified today to urge debt service and repayment. The government ought to start negotiations to relieve the situation caused by the debts.

According to the *global politico-economical* objection, Hungarian indebtedness has to be considered as part of the worldwide crisis af-

fecting a great number of developing and half-developed countries. Thus, it ought to be managed within this framework. Therefore, the representatives of this view support a comprehensive, global debt settlement.

The *economic* criticism has been formulated by foreign (R. Dornbusch, P. Hare, J. Sachs, R. Portes) and domestic (A. Inotai, M. Patai, Gy. Szakolczai, T. Révész) experts. In their opinion Hungarian debt management cannot, in the long run, be maintained. According to their proposition the burden of the debt (service) should or ought to be mitigated by negotiations. The latter would be conducted with western governments or international bodies. It is an important circumstance that most of those who profess this opinion imagine that the debt can be relieved in such a way that the country can, in the meantime, maintain its solvency and creditworthiness. Hence, between immediate payment and rescheduling there must be a third way which ought to be attempted.

In Oblath's opinion the credit relations in the background of the problem of indebtedness cannot be managed either as emotional, ideological or even political questions. Therefor he distances himself from these approaches. In opposition to the economic criticism he refers to the impracticality of the proposition. He points out that it is not clear who it would be necessary to negotiate with; this is because the credits stemming from governments and from other official quarters amount to only a small part of the whole credit stock. The debt embodied in bonds is rather considerable and thus in the case of bonds it is not at all certain who the negotiating partner would be. Notwithstanding the factors mentioned above, according to Oblath even the time horizon of those supporting the present debt strategy is not quite clear. However, he believes it is right to say that even the rumour of an alternative strategy would impede current crediting, would undermine the international liquidity of the country, and would cause an outflow of capital; finally it would make the credit transactions of the commercial banks impossible (at a time when they have just appeared on the international scene). It can hardly be doubted that the revision of the current debt strategy would cost a great deal. On the other hand, Oblath concludes that although it causes anxiety, the present debt is often considered not a burden but expressly a blessing, for it acts as a bludgeon needed for enforcing adjustment.

The NBH's study looks at the technical side of the critical suggestions. The first one the study deals with is a one-sided announcement of a moratorium on payments. According to experience gained with regard to this, the countries who have followed this way, have needed a very long time to regain international creditworthiness, and to be able to finance their foreign contacts. The study says that in Hungary's case this would be absolutely irresponsible adventurism. Resorting to the means of rescheduling debts is necessary only for a country which is unable to pay the charges of its debt. Making the agreement on it needs a relatively long time, for agreements have to be made with a great number of creditors. It is mainly the rescheduling of the amortization that comes into question, for, in principle, the interest should be paid continually. Even announcing such an intent would cause serious damage. It is the improvement of credit-worthiness which can help relieve debt burdens, via the inflow of foreign capital. With regard to the application of techniques for reducing debt burdens the study mentions that "... in foreign money markets it is an unwritten rule that it is not ethical for the debtor to repurchase a slightly devalued bond, since the cause of devaluation is (or ought to be) precisely the publicly-known critical position of the debtor, regarding the debtor's payments" (p. 71). It follows from this that an ethical debtor makes efforts to revalue the bonds and purchases them only after the revaluation.

The debt-equity swap, in the opinion of the NBH, deteriorates the chances of privatizing state property and reduces the incentives for the inflow of foreign venture capital, which are linked to privatization. "Linked to privatization, the inflow of foreign venture capital up to now may be estimated to amount altogether to USD 1 billion. If, instead of privatizing state property for cash the programme of the debt-equity swap had been preferred, apart from anything else, in the balance of payments the income of foreign exchange would have been one billion dollars less.

This might have meant that even the level of the current foreign exchange reserves would also have been lowered, or the replenishing of them would have required raising much larger credits. In addition, it would have been necessary to count with a much higher amount of net profit transfer, which is also a charge on the current balance of payments" (p. 72). Here too, a certain one-sidedness can be detected: how can it be forgotten that although an incidental debt-equity swap reduces the debt, it also places burdens on it? This directly influences the balance of payments, as well as the above-mentioned capital inflow. This issue cannot be settled by the phrase: "apart from anything else".

As is shown by international experience, the foreign investor endeavours to depress, to the greatest possible degree, the values of the capital property offered in exchange for the debt. Therefore, this technique entails immeasurable consequences with regard to the domestic revaluation of property. At the same time, this technique might have elicited unforeseeable processes in the price level of Hungarian bonds abroad" (p. 72). In this train of thought neither the commonplace term "international experience", nor sharp attributes can substitute for the missing arguments. Nevertheless, we must accept that if a consequence is "immeasurable" or a process "unforeseeable", it cannot be described; but even so, such reasoning is insufficient to make this felt merely by using some attributes.

To the reader nothing is left but to recognize that in the analysed period the National Bank of Hungary, in the sphere of debt management, could not do anything other than it did. In addition, what it did was always the best thing to do.

What does the future have in store?

According to the NBH the future can be built upon two stable points. *One* of the stable *starting points* is that Hungary can be seen to have passed the most difficult stage of changing into a market economy. The *other corner stone* of key importance is that on the foundation of the developing stabilization and framework of conditions for a market economy, getting out of the recession is a realistic prospect. Furthermore, exports will be the major motive force of economic growth. As a result of this "...the proportion of the declining stock of debt to the GDP will strongly diminish, and by the end of the decade the ratio of the non-growing, perhaps even decreasing debt service to the growing exports will also considerably lessen" (p. 79). In order to realize this image of the future it is absolutely necessary (and indeed, unavoidable) to take the principles of external debt policy into account. In conformity with these, it is necessary to maintain foreign creditworthiness and to avoid the cyclical economic policy which was characteristic in the past. Furthermore, it will be expedient to decrease the net stock of debts and to urge the inflow of venture capital. It may also be tolerated that the current balance of payments might be slightly negative. Finally, in the coming years foreign exchange reserves have to be increased (even if not continually and to a great extent) owing to the growing imports. The latter is for the sake of strengthening safety and in order to be ready to meet excessive liabilities of payments. The structure of the foreign exchange reserves has to be maintained so as to be favourable with regard to the maturity of the debts within the overall debt. Moreover, the costs of the debt should be reduced to the lowest possible level.

When drawing up an image of the future, Oblath applies two assumptions. According to the first one, that part of the debt service which consists of interest payments has to be, in its totality, covered from the positive balance of trading in goods or services. This means that neither capital inflow, nor unilateral profit transfers must be reckoned with. The other one means a forecast according to which, in the future, the amount of capital inflow will at least reach the amount of the interests to be paid. The countervalue of transfers destined to go abroad may be created by an economic policy which increases taxes, or which reduces state expenditures, or steps up inflation, or which raises the size of the internal government debt. All of these solutions would bring about new tensions. Consequently, growth without tension can only be achieved if the second assumption is realized. His conclusion is that if no serious trou-

ble occurs and domestic economic policy does not make great mistakes, Hungary may count with a foreign capital inflow which will allow the foreign debt service to remain manageable. There were many, including Oblath himself, who expected western governments to make contributions to the costs of transforming the system by granting considerable support. However, in the event the West actually granted no significant support, and today this situation cannot be basically changed. The majority of the countries in the region suffer with far more serious troubles, and if notable state resources from the West could at all be reckoned with, these will not flow to Hungary. If the troubles in Hungary become too great, we would be likely to obtain some support. However, Hungary can hardly expect support for preventing such an outcome. This is why he thinks that debt management has no feasible third way. If the inflow of private capital continues, the problem of debt management remains manageable. Should the inflow of capital stop, it is very likely that a serious situation would arise. This might even enforce a revision of the present debt strategy. However, making a revision of the debt strategy at the present time would impede the inflow of capital, and this would cause more harm than benefit to the country. Hungary must strive to remain a good debtor and be creditworthy—Oblath finishes his arguments by saying that nothing wiser or more responsible can be done in the present circumstances.

As a conclusion, two remarks are indispensable. Even such high-level analyses as the ones surveyed in this review are not free from a bias towards a positive image of the future. Readers will not receive real answer to the question as to the consequences on debt management if only a low level of capital inflow is realized. We still know very little today about the long-term behaviour and strategy of companies working with the participation of foreign capital. Thus from this aspect it is necessary to think of some alternatives. The NBH has formulated its principles concerning foreign debt strategy with no apparent regard for economic processes. To give an example: is it really necessary to attempt to realize a continuous increase in foreign exchange reserves, and to do this irrespective of the internal processes? Where is there an analysis of this, based on cost-benefit relations? This must not be a question that falls exclusively to the authority of the NBH.

Finally, foreign debts are more and more falling outside the sphere of the authority of the NBH, because the commercial banks and companies are also entitled to raise foreign loans. How is the country's creditworthiness going to develop and how far will the NBH be able to take care of both?

L. HALPERN

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SZÉKELY, P.–NEWBERY, M. G. (eds): *Hungary: an economy in transition.* Cambridge: Cambridge University Press—Centre for Economic Policy Research. 1993. 359+xxvii p.

This is an interesting and very valuable collection of studies on the Hungarian economy. It is characterized by great attention for detail, and as a whole it provides a fascinating overview of the state of the Hungarian economy at the beginning of the 1990s. Also to its merit is the fact that it contains little repetition of earlier research on the Hungarian economy.

The wide variety of topics and the high level of analysis make the volume of interest for a large readership. I expect that most scholars working on the problem of transition in post-socialist economies will find one or more chapters in this book to be of interest. For researchers dealing with aspects of the Hungarian economy, the book is indispensable.

The book shows that despite the major political change that took place during 1988–1990, the developments in the economy are best understood when seen as a continuous process. A further interesting point about the volume is the confrontation of different views. For instance, there are important insights provided by the contrasting interpretations on Hungary's debt problem and the disintegration of the CMEA. Before discussing these aspects in more detail, let me summarize the contents of the book.

The volume consists of seven parts. *Part one* deals with foreign trade. László *Csaba* (*Ch. 2*) discusses the disintegration of trade between the former member states of the CMEA. His main argument is that, in Hungary, trade reorientation towards the West had already started in 1987 and 1988. In other words, it began before the socialist system collapsed. This reorientation was not directly due to governmental action, but partly the result of a spontaneous process of enterprise decisions. *Chapter 3* is a brief statement by Kálmán *Mizsei* on the prospects of regional cooperation in East-Central Europe. This is followed by an econometric analysis by László *Halpern* and István P. *Székely* (*Ch. 4*). This analysis deals with export supply and import demand in the period 1968–1989. The novel aspect of their model is the very definitive account of export subsidies and import restrictions. This is different from earlier studies, which did not make this distinction explicit. The authors found that there was already a positive supply response from Hungarian enterprises to price changes on the world market in the period prior to the disintegration of the socialist system in 1989.

Part two of the book is concerned with privatization and competition policy. The core of this part comprises a very detailed and interesting study by Péter *Mihályi* on the process of privatization (*Ch. 6*). I will discuss this in more detail below. János *Stadler* gives a clear and useful overview of competition policy since 1990 (*Ch. 7*). These two chapters are preceded by a short paper by Zsigmond *Járai* (*Ch. 5*). However, although of interest in itself, this chapter is somewhat vague and adds little to Mihályi's analysis.

In *part three* the financial system is discussed. Júlia *Király* presents a short-run model of the money market (*Ch. 8*). In *Chapter 9* Éva *Várhegyi* discusses the banking reforms of 1987 and the problems resulting from the limitations of these reforms. In *Chapter 10* István *Ábel* and István P. *Székely* deal with the changing structure of household portfolios in the period 1970–1989. This is an interesting topic which has attracted little attention in the study of post-socialist transition.

Part four deals with foreign debt and monetary policy. *Chapter 11* is an excellent study by Gábor *Oblath* on the composition and development of Hungary's foreign debt and its macroeconomic implications, while in *Chapter 12* Werner *Riecke* gives a valuable outline of the approach of the Hungarian National Bank to the issue of debt management. I will return to these chapters below.

The remaining parts of the book are concerned with miscellaneous topics. *Chapter 13* contains a brief enumeration by Tamás *Sárközy* of the main economic laws passed since 1968. *In Chapter 14* Jenő *Koltay* gives an intriguing and very critical account of the tax reforms of 1988, which introduced value added tax and personal income taxes. These reforms have repeatedly been legitimized by reference to international experience, yet Koltay shows that they actually followed a model which has been and is dying out in market economies. Implementation was clumsy and was dominated by all sorts of exemptions. János *Köllő* discusses shop floor bargaining in Hungarian industry (*Ch. 15*). He analyzes the degree to which search costs and the costs of shirking (absenteeism) and contract enforcement have changed since the 1968 reform. He also looks at the gradual spread of the second economy and the sudden changes that have taken place 1989. *Chapter 16* is a passionate treatment of the problem of pension funding by Mária *Augusztinovics*. Finally, *Chapter 17* by István *Ábel* and John P. *Bonin* is concerned with "state desertion": that is, the problem of the partial disappearance of the state when the socialist system disintegrated, while at the same time its role was not (and, as yet, has not been) replaced by any other mechanism of economic coordination. This notion is applied to the problem of how to implement convertibility.

A recurrent theme of the book is the continuity of the reform process in Hungary. At first sight one would be inclined to regard the year 1989 as a clean break. Without doubt, the economic situation in 1992 differs radically from that in 1986—both in absolute terms and as regards the process of economic change. Yet as witnessed by many chapters in this book, a lot of change had already been taking place in the years preceding 1989. These changes were not just restricted to government policy (such as the banking reform of 1987 discussed by Várhegyi in *Chapter 9*, or the tax reform of 1988 analysed by Koltay in *Chapter 14*), but also manifested themselves in economic behaviour at the micro level. For instance, the redirection of trade from the CMEA to the West started in 1987–1988, and it was largely independent from any official intention (Csaba in *Ch. 2*). In their introductory chapter, the editors argue that the legacy of the reform process had a positive impact in the early stages of the transition process, to an extent that was larger than originally expected. Earlier reforms "enabled the authorities to learn from experience and to accumulate expertise and confidence in market-oriented reforms" (p. 15). Another advantage of the continuity of reforms was its credibility and predictability. This was especially important in attracting foreign direct investment.

A very interesting analysis of the process of continuity is given in *Chapter 6*, in which Mihályi looks at privatization. Although the reform measures in the period 1968–1988 "were insufficient to raise the country's overall economic performance", Mihályi argues that "[...] the magnitude and persistence of these steps were large enough to narrow the spectrum of choice in the present" (p. 88). The development of a limited degree of entrepreneurship in the state sector during the 1980s, for instance, put a barrier to centrally orchestrated privatization programmes, such as voucher schemes, as these would have met considerable resistance from the incumbent management. Similarly, the legal changes and the limited inflow of foreign capital during the 1980s made the country—in first instance—more attractive to foreign capital than other countries in the region. This again provided an incentive to sell state enterprises individually, instead of distributing ownership rights for free (i.e. "giving away" ownership rights) to the population.

Mihályi's argument on the limitations of the scope of manoeuvre for the government brings home an important insight in the transition process of post-socialist economies: none of these economies can be considered as a *tabula rasa*. The process of transition does not start from scratch. Each of the countries concerned has an economic history of its own and the possibility of lock-in by past events cannot be excluded beforehand. Although this argument is not new, it deserves more attention. This is particularly true with regard to the fashionable comparisons *among* the countries in transition; these comparisons include those between "gradualism" in Hungary versus "shock therapy" in Poland, or "quick" privatization in the Czech Republic versus "slow" privatization in Hungary.

I should add immediately that the argument of the *possibility* of lock-in past events should not be confused with saying that present events are necessarily *determined* by the past. In the context of the present review this can best be illustrated by certain shortcomings in the economic policy pursued by the first democratic government, led by József Antall. In fact, the book does not present a detailed assessment of the economic policy of the Antall administration. Yet, at several places the reader can find a critical evaluation. In my view, the most serious problem presented by the Antall government is the low priority economic issues have received as compared to other issues, such as that of the Hungarian minorities abroad and other national issues (this point is raised by Mihályi in a footnote on p. 111). The various ministries and government agencies all in their own way have been trying to help the establishment of a market economy. However, these efforts have not been coordinated by the prime minister, and as a result the reform process has been unnecessarily delayed. Particularly urgent is the reform of the banking system (see Várhegyi's views in *Chapter 9*). All in all, I am afraid that the relative advantages of the Hungarian reforms have been gradually eroded over the course of time, in particular during 1992 and 1993. (Nevertheless, this

is not reflected in the volume, which was completed in early 1992.)

An important merit of the volume comprises the comments and discussions accompanying each part. In many places these comments go beyond an individual evaluation of the papers concerned. Consequently, they greatly add to the value of the original papers, as good comments indeed ought to do.

Let me single out one part of the book in this respect: the one on foreign debt and the required policy response to the debt problem. This part consists of two papers, by Gábor *Oblath* and Werner *Riecke* respectively, followed by comments of L. Alan *Winters* and Richard *Portes*. As Oblath takes an intermediary position in the debate, let me first sketch the views of Riecke. He emphasizes the importance of re-financing outstanding debts, and argues that there should be no question of using any kind of debt rescheduling. Indeed, leading officials of the National Bank of Hungary should emphasize this. The key issue in Riecke's view is an appropriate restriction of domestic credit and the public sector budget deficit. His view is challenged by both Winters and Portes. They cast sincere doubts on the ability of the Hungarian economy to generate any substantial growth under the current debt burden. Therefore, debt reduction has to be a major part of the solution. As Winters says, "keeping up the payments just in order to be able to enter next year with the same level of debt as last is not good economics". Portes is strongly in favour of debt reduction: he refers to the example of Mexico, where this, in combination with reforms, helped the economy to return to a path of growth.

Oblath gives a more balanced view. Before discussing his views on debt policy, it should be noted that his paper gives a very detailed analysis of the development and the structure of Hungary's foreign debt. The most astonishing fact is that 80 percent of the increment of debts between 1970 and 1990 is explained merely by net interest payments. In view of this observation it is not surprising that Oblath is less dismissive about debt renegotiation than Riecke. Yet, he sees a number of practical problems. First of all, foreign debt is spread among a large number of creditors, and many of these are holders of Hungarian bonds. This makes renegotiation extremely difficult. Secondly, Oblath is sceptical about the willingness of the West to give assistance. The idea of debt relief has, at least until now, been restricted to academic circles. His main conclusion is that Hungary will be able to manage its foreign debt as long as sufficient capital flows into the economy, either as foreign direct investments or as unrequited transfers. This may or may not materialize: neither possibility is excluded entirely.

Of the four contributors to the section on foreign debt, Winters is the most sceptical. He is in agreement with Oblath and Riecke on the implausibility of successful renegotiation, but he also agrees with Portes on the dim macroeconomic prospects under the present debt burden.

Although the book as a whole is high calibre material, it does not escape minor imperfections. Some of the chapters are too short to treat their subject really thoroughly: for instance, *Chapter 3* by Mizsei, *Chapter 8* by Király, and *Chapter 17* by Ábel and Bonin. By far the weakest contribution is a chapter entitled "Conclusions" by Adam *Ridley*. After 346 pages of detailed analysis, the author tries to summarize the main issues in 6 pages. The reader should have been spared this mixture of personal impressions and superficial policy advice.

Other minor shortcomings: readers with little knowledge of Hungary would have been helped by a somewhat more extensive overview of basic developments. For instance, a brief discussion on the political developments since 1987 would not have been superfluous in the introduction. Similarly, for a book emphasizing the legacy of the Hungarian reforms under state socialism, more references to the literature on that period would have been in order in the introduction.

Finally, the book does not contain much analysis of developments on the level of markets or firms. I regret this particular omission for two reasons: firstly, because this is one of the most exciting aspects of the transition process; secondly, because Hungarian economic science has a strong tradition in this field. This unfortunate neglect is, however, well com-

pensated by the inclusion of innovative research into hitherto neglected areas. Moreover, researchers interested in the transformation of firms and markets in post-socialist economies will find the book invaluable because of its detailed analysis of the environment in which firms and markets are operating.

In sum, this is a fascinating book. One can only hope that similar volumes will appear on other post-socialist economies in transition.

W. SWAAN

PORTES, R. (ed.): *Economic transformation in Central Europe. A progress report.* A joint publication of the Commission of the European Communities (Brussels) and the Centre for Economic Policy Research (London), 1993. 294 p. + index.

It is an encouraging sign that—unlike in 1990 and 1991—this year the EC, recognizing the qualitative differences of the Central European situation, has devoted a special analysis to the Visegrád countries, as distinct from the ex-Soviet Union and the Balkans. This is a noteworthy gesture since—in line with the facts—at last it fulfils a basic analytical precondition; namely, that successful political strategies and correct economic evaluations are impossible, particularly in Europe, if they are worked out on the vague and outdated general category of "the ex-socialist countries". The respective destiny of each of these countries has demonstrated an ever increasing divergence from the—in many ways accidental—legacy of their recent past.

The authors of this volume are opponents of shock therapy. At the same time, the text takes the form of dialogue. The dialogue analyses the benefits and problems of the transition so far. In other words, the academic community dealing with this theme makes no claim (as many would have thought indispensable) to represent a single/consensual perspective (which is a choice itself open to many interpretations).

The regional overview was written by two transition experts, Mario *Nuti* and Richard *Portes*. They are both known opponents of the neoliberal orthodoxy, which is assumed to be dominant in Central Europe. Their wide-ranging survey convinces them that in the Visegrád countries and the five Eastern *Laender* of Germany he transition to a market economy has proceeded at higher cost and with less success than it could have been. Their Keynesian critique of the transition's plans—and in part practices—rightly includes (page 6), the major problems that need solutions—i.e. the fiscal disequilibrium, social insurance and the banking system; these are significant economic phenomena in the region's conflicts. Although doubtless at too great a length and with too great emphasis, the authors rightly condemn the Visegrád countries' lack of magnanimity towards one another in finalizing the CEFTA, as well their response to the collapse of trade with the East. Here, two special points are worth highlighting. These, according to Nuti and Portes, can serve as lessons for those transitional economies that have not had the experience of the Visegrád countries. One is that Russia, given the extreme lack of equilibrium and the presence of lasting structural deformations, should, in theory, be given even more extreme shock therapy than Poland. However, since this is impossible, specific sectors should be dealt with on a case-by-case basis (e.g. energy, agriculture). In this way, they believe, results can be achieved independent of what happens to the macroeconomy (p. 14). This suggestion reminds me of the vast literature that tries to rationalize the Soviet pseudo-reforms of the post-1979 period. Other further interesting observations relate to the often raised question (e.g. by Alec *Nove*, W. *Brus*, etc.) of whether reform-socialism could have worked. Their view is that it would not have done because neither the will, nor the political legitimacy, was available for broadening the reforms needed for a change of system (p. 20). This point is important, as a number of Hungarian and Polish contributors to this report—

Conferences and volumes of essays are not easy to review. The reader finds here two reviews on a volume published by CEPR, one of the proliferous transformation research centers. Please, regard this as an attempt to taste two different review types. Comments are welcome. (Ed. note)

Riecke and Antal (p. 109), D. *Rosati* (p. 227) and *Mizsei* (pp. 133–135)—stress the continuity between the two processes.

The Czech and the Slovak processes have been analysed as a unified entity since the manuscripts were submitted at the end of 1992. As supporter and economic advisor of the conservative government, Ian *Sveinar* (who is also a professor in Pittsburgh, and at the moment director of the Institute of Economics of the Czech Academy), introduced some facts on transition. In his evaluation he emphasized (p. 21 and especially p. 55), that amidst the reformist ideology the practice of stabilization was characterized by minor macroecomonic changes only. The other side was presented by Valtr *Komarek*, the former president of the Institute for Forecasting and then chairman of the Social Democratic Party. The most interesting thing about his contribution is that more than half of it is devoted to publicizing his party's official economic policy programme. Komarek follows the tradition of the Czech structuralist school and thinks in terms of the traditional Czech welfare state; therefore the transition for him has been an obvious failure. First of all, he chastises the transition for the fall in production and employment that have accompanied. Secondly, he criticizes the structural regression and the low exchange rate, which he thinks have led to a nea-colonial dependence on Germany (p. 100). Finally, he points to the debilitating effect of the newly emerging world of speculators, and the irresponsible squandering of state property (pp. 83–84).

The author illustrates these and other contradictions with the help of detailed information. Indeed, he sounds convincing when argues against the vulgar character of the policy of haste, with the damage it has caused due to the rush for privatization. On the other hand, he does not devote much attention to the fact that free distribution of property has been increasingly replaced by traditional methods of privatization (*Mejstřik* 1993). It is also fairly surprising to notice the deep conviction with which he labels as a 'new strategy' the economic policies what in fact represent an old-fashioned Keynesian alternative. In these he is joined by Rosati. Even if one accepts this approach as a feasible theoretical model, the practice and experience of the past fifty years, starting with 1930s, should not be forgotten. Without this, the Fridmanian counter-revolution would never have penetrated so deeply the economic policy of so many countries during the last 15 years. *Nota bene*: the balloon of Clinton's new deal has been punctured much earlier than expected, even by its enemies. This vital point should be kept in mind, especially when 'new alternative' economic policies are being urged for transforming nations.

Werner Ricke and László Antal portray the Hungarian transition as a conflict between a healthy monetary policy and an ill-founded fiscal policy. Their generally professional and balanced analysis in some parts becomes a bit one-sided. The best example of this is that Hungarian export successes in 1990–92 are attributed entirely to the austerity in monetary policy, and they tend to ignore the quite complex processes of microeconomic adjustment, the liberalization of imports and the collapse of the CMEA. In addition, they do not mention the softening of monetary policy which has been taking place since September 1991. At the same time, they prove with uncontestable arguments that large budget deficits in Hungary will have an increasingly *destabilizing* effect both in the short and long run (p. 130).

Kálmán Mizsei appears as an author in this volume, presumably, because of his political activity.[5] His broad overview, however, is free from ideological prejudice. Leaving aside the hotly debated controversies of the economic strategies to be found in the respective parties' policies, Mizsei focuses on the *evolutionary* character of Hungarian developments. He stresses the advantages and disadvantages of individual policy options. He strongly emphasizes that the Hungarian transformation has been 'socially sensitive'—i.e. it has averted and avoided conflict; however, he sees a paradox in that successful results in the short run are likely to trigger more problems in the medium-term. As far as the reform of the social security system is concerned, even the liberal opposition—"for misin-

[5] He has been a chief economic advisor of the smaller liberal opposition party in Hungary, FIDESZ.

terpreted ideological reasons" (p. 115)—has refrained from elaborating its own radical alternative which would go beyond simply condemning the official policy of postponing necessary cuts. The only disputable statement of this well-founded study is the contention that privatization of certain large banks could have been started as early as 1989–90 (p. 176). In fact, the portfolio of commercial banks has been so bad that some bankers rightly ascertain (*Bokros* 1993) that, currently, those willing to pay the face value for the bank shares should actually have been paid for their inevitable losses. While emphasizing the continuity embodied in the changes, it should be kept in mind however, that ever since 1953 (but particularly during the Grósz and Antall governments) economic common sense—including the need to face constraints—has paved its way only against the tide of the official deliberations of the day. This also implies that actual priorities and trends in economic policy have shown a fairly weak correlation with governmental declarations and self-interpretation (Csaba 1992).

Two Polish authors, both slightly ideological in their approaches, provide good insights into the Polish reality. They are convincing when demonstrating how far from reality were those who believed that a market economy could be reached in the space of 3–6 months with a single leap (*Lipton and Sachs* 1990). The same criticism can be applied to those who, during the Olszewski government, experimented with a populist, growth generating policy. This stood in sharp contrast with the previously followed Balcerowicz line, as well as in contradiction to the economic realities. It is also very thought-provoking to consider how modest the level of institutional development in Poland actually was, when it was declared overseas to be the favourite reformist country. *Gomulka* points out that alongside the complete absence of bankruptcies, two thirds of the budget deficit has been financed directly by the central bank (p. 195). In this context *Rosati*'s arguments on non-inflatory demand stimulation are not particularly convincing. At the same time, Rosati makes many important and relevant points. The most noteworthy is that on the labour-maximizing behaviour of state-owned enterprises. This is a logical outcome, given the soft-lending practices and the lack of enforcement of the bankruptcy law. Along with many other details he also demonstrates (p. 234) that, in 1990–92, government-led privatization at best resulted in limited changes in actual ownership. Out of 8500 state-owned enterprises only 2100 were transformed into share-holding companies and only 52 actually went into private hands. In other words, the much debated theories and official programmes remained highly irrelevant.

Although this policy-oriented volume does not offer too many theoretical novelties, it gives a rather detailed and colourful picture of countries in Central Europe. One can learn a lot about the background of many ideas and facts. Inherent linkages between different economic and political lines of thought become perceptible, although this fact has recently been contested by some famous experts. The editors should be praised for their pragmatism, the authors for their sincerity, and the publisher for placing before an international audience these findings, which are so important for us.

L. CSABA

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Mejstřik, M. 1993. "Vouchers, buyouts, auctions: the battle for privatisation in Czechoslovakia", in Köves, A. *et al* (eds) *op. cit*.

Conferences and volumes of essays dealing with the questions of East European transformation are mushrooming, both in the East and the West. Intensive communication between theoretical economists, economic advisors and practising economic politicians is indeed badly needed, since the problems and difficulties of economic transition that have actually occurred have for the most part been unexpected by politicians and experts as well. However, the extremely high number of conferences per capita entails certain disadvantages too: it prevents or at least makes it difficult for economic analysts to pursue really profound research into the basic processes and innermost forces motivating East European transformation.

The volume edited by Richard *Portes*—as with a number of other works published on this subject—consists of materials written by authors invited from East European countries. Comparing this volume to other publications of this kind, it can only be praised, because some of the papers contain deeper analyses than customary. It also calls attention to some important factors which have so far markedly influenced the speed, costs and losses of economic transformation.

Another merit of the book is that it strictly adheres to the sphere of its subject matter. The authors deal only with the countries of the East Central European (ECE) region (the "Visegrád four"). Only the introductory study written by Portes and *Nuti* touches upon the case of the former GDR, as an extreme but rather special case of "shock therapy". However, the limited sphere of the analysed group of countries might have allowed for more meaningful comparisons between the countries concerned. As a matter of fact, the essay by Portes and Nuti, which introduces the volume, hints at the fact that the ECE countries, though being transformed from seemingly very different initial situations are, surprisingly, struggling with similar problems. The comparison, however, stops at this point. What is also praiseworthy is the point that the authors have avoided the pitfall of playing the game entitled: "Who is winning the race for transformation?"

In principle, the structure of the volume follows the arrangements of a drama in which the participants "keep answering". After the introductory study, there are the writings of two authors for each of the three countries (Czechoslovakia still appears as one country). The pattern of the book involves one of the authors emphasizing the successes achieved by the transformation, while the other tends to list the failures and those costs which have turned out to be much higher than expected. The most successful example of this method of answering the issues is that produced by the Polish team: i.e. by the "optimist" Stanislaw *Gomulka* and the "pessimist" Dariusz K. *Rosati*. Though there are sharp differences between Jan *Svejnar* and Valtr *Komárek* on the Czechoslovak transformation and the ways of approaching it, they avoid giving direct answers to one another. The Hungarian team, represented on the one hand by the pair of authors László *Antal* and Werner *Riecke*, and by Kálmán *Mizsei* on the other, have produced a pair of articles which follow a pattern slightly different from the others in the book. While Mizsei has made critical remarks with regard to the political frameworks and circumstances of the economic transformation, Antal and Riecke have not dwelt so much upon political problems but have depicted fairly gloomily the majority of the economic processes (with the exception of monetary policy).

Every analysis dealing with the actual situation in Eastern Europe is subject to the danger that by the time the work is published, the questions discussed are no longer as relevant as they were earlier. However, this volume (in all probability due to the working capacity of the editors and to the diligence of the publisher) has been able "just to catch" the main and most distressing problems of the ECE countries: namely, economic recession and unemployment. With regard to the former problem, there are plenty of interesting findings in this volume. The joint work by the authors Nuti and Portes, and the work by Rosati are good examples of such findings. However, as far as unemployment is concerned, they could only record the problem. The only exciting comparative analysis in the book about the reasons for the differing Czech and Slovak rates of unemployment has been written by Svejnar. More will be said about this below. The papers by Svejnar, Gomulka and Miz-

sei deal with the recurring question of "whether or not to apply shock". Yet these merely arrange the facts in groups and there are no in-depth analyses of the issue. Antal and Riecke have analysed one of the important and far-reaching problems of Hungarian stabilization: i.e. the tension between monetary and fiscal policies and their tendencies. Similar analyses can also be found in Mizsei's work, but these are not really profound ones.

The introductory study of Nuti and Portes presents a wide-ranging review of transformation in the ECE countries. From this comprehensive picture I now wish to emphasize two elements. One is the group of findings as regards the *extent and causes* of economic recession; the other one is their standpoint in relation to the question of shock therapy vs. gradual transformation.

For all those who are familiar with the "6 points" of János *Kornai* which, in his opinion, explain the Hungarian economic recession (see *Közgazdasági Szemle*, 1993, Nos 7–8, pp. 569–99), it will be especially interesting to compare these with the views of Nuti and Portes. While the authors admit the negative influence of the CMEA's collapse and of the factors that necessarily accompanied it and their influence on economic growth, they also point out other factors. First of all, in their opinion, with the disintegration of the CMEA markets and the extraordinary losses in terms of trade, it was not only the "elemental disaster"-like processes, but also the wrong economic political measures on behalf of the ECE countries that played an important part. However, they also think that a direct contribution to the deepening economic recession was made by the full liberalization of foreign trade. This neglected all the possible negative effects and preceded the structural transformation of the economy. In addition, the crisis was aggravated by the fact that the credits destined for the enterprise sphere were too strongly restricted. The excessive devaluation of the currencies, and in some cases their overvaluation (e.g. in Hungary), the procrastination of privatization and, at the same time, the abandonment of the remaining large-scale state-owned sector (p. 4) also exacerbated the situation. Linked to the latter processes, the authors urge an institutional solution to the handling of state property, as well as the application of the instruments of industrial and commercial policies. In this latter respect Nuti's and Portes's otherwise instructive comments are highly debatable, and they do not set out clearly what those solutions are that they feel can be carried out by the state.

With regard to the character and the extent of the economic recession, the authors question the validity of the hypothesis of the so-called "J-curve", and also that of Schumpeter's "creative destruction". They believe that the economic recession of the ECE countries can be better characterized by the "L-curve". The latter implies that the negative growth processes which started at the beginning of the transformation have not been reversed (as was assumed by the hypothesis of the J-curve) but, after having reached the trough, have continued alongside a long-lasting stagnation which is still present even today.

Nuti and Portes, on the other hand, reject the opinion—stressed first by western government-advisors, and mainly by Jeffrey *Sachs*—that, owing to the collapse of the East European statistical system, the recession exhibited by statistics is much more serious than it is in reality. They sum up their counter-arguments in six points (pp. 9–10):

1. Some of those western analysts who doubt the recession denoted by official statistics and suspect that the statistical services of the countries concerned manipulate the data, often also themselves change quite arbitrarily the data they publish about some countries. (Nuti and Portes here refer to the different versions of a paper jointly compiled by the authors *Sachs and Berg*.)

2. In a centrally planned economy some incentives tended not only to exaggerate actual performances, but often served to diminish them so that company managers could obtain, for a given output, more input sources. For the time being, it is not unequivocally clear why and when something is published in the statistical data.

3. The increasing output of the private sector usually stems from the service sector. In industry, however, the private sector is rather weak. Though it is undoubtedly

true that the backwardness of the service sector renders its enhancement necessary in order to improve economic efficiency, its growth ought to come into being at the cost of agriculture rather than that of industry.

4. Although statistics may underestimate the performance of the private sector, the extent of this underestimation is, in all probability, lesser now that the private enterprises have gained legality, compared to earlier times when they worked in illegal or semi-legal forms. Consequently, the *growth* of the private sector is probably *overestimated* by statistics.

5. A number of western analysts hint at the fact that statistics do not measure the welfare surplus of customers generated by an easier access to markets and commodities. This is true, but the calculations of the national income never take account of this surplus—not even the statistics showing the GNP of western countries' include this. Furthermore, it has to be asked whether it is justified to refer to welfare surplus when, on the other hand, the consumers suffer significant losses, owing to rapidly growing unemployment and uncertainty.

6. It is a much favoured argument of western experts that the regression of production is mainly a semblance because it is chiefly the closing down of the manufacture of products "not demanded by the market" that have come to the fore. Yet an argument which is based on a demand that exists or is missing in the market can only be accepted in knowledge of the prices. For, if there is no demand for a product, its world-market price must be extremely low. In extreme cases such products contain a negative value added calculated at the world-market price. As a consequence, giving up the making of these products should not reduce, but *ought to increase* the gross domestic product. Owing to the fact that this still did not happen, the question rightly arises: Is it really only a question of measurement? Or, was it the market which was still not properly operating in East Central Europe? In other words, it was not necessarily the products or processes not demanded by the market—and using up some added value—that ceased to exist, but their selection was rather incidental and not rational enough.

The analysts' debate on shock therapy versus gradualism is linked to what has been said above. According to Nuti and Portes, this debate is superfluous. If there is at all any ECE country where we can speak about "shock therapy", it is the former GDR. Otherwise, the question is not whether or not to use shock therapy, but the sequence and extent of the necessary economic-political measures. Nuti and Portes point out that in a few East European countries the extent of the measures used for stabilization have been excessive. At the same time, the endeavour to create appropriate harmony between stabilization and the measures aimed at institutional transformation, has failed.

The authors emphasize that the possibility for the ECE countries to choose between shock therapy and a gradual solution is much lesser than it seems to be on the basis of the discussions. The transformation process itself entails such shock effects and forced reactions of adaptation anyway that these could be strained by artificial shock instruments.

In the light of the foregoing it is not quite clear why the authors want to enforce the introduction of convertibility of currencies in the ECE countries. They believe that in the case of Hungary postponement of the introduction of convertibility is not simply the result of a delaying economic policy but directly follows from Hungary's determination to pay its debts under any circumstances. The authors lengthily depict the favourable effects of rapidly introducing convertibility on foreign trade, domestic prices and on market development. They hereby somewhat contradict themselves, since earlier they had argued against changes that were too fast. It is also not fully clear how they imagine convertibility without a wide and speedy liberalization of foreign trade when, at the same time, they deem such liberalization to be harmful. It is true, however, that they would link up the introduction of convertibility of currencies with the application of some protective tariff system. Finally, it also remains unclear as to what the authors understand by convertibility. For instance, would they allow convertibility in capital transfers too, or do they envisage a kind of

convertibility which can actually come into being in Hungary very soon?

Jan Svejnar deals with the Czech and Slovak transition as if the two independent republics were still one federation. According to his analysis and evaluation, transformation is progressing successfully, despite the fact that stabilization, liberalization and massive privatization are going on amidst an economic recession. Svejnar believes that the brake put upon the rapid growth of unemployment, and the maintenance of the financial equilibrium of the economy have been successes. At the same time he points to a few differences between the Czech and the Slovak transformations, including the fairly different political conditions. Nevertheless, from his analysis it seems that the two countries have, since their independence, proceeded in the same direction, although they have used different methods. While in Bohemia radical, shock-like changes have prevailed, Slovak economic policy has selected gradual transition at a slower pace.

What is missing from the analysis is deeper research into the efficiency of the still dominant state-owned sector, and of public finances; also no account is taken of the fact that both in Bohemia and Slovakia, the rules and proceedings for dealing with bankruptcy will from now on be strictly applied.

Svejnar considers the Czech solution more successful and promising than that of Slovakia. Yet he calls attention to the fact that the different methods followed in the two countries are mainly the inevitable results of the highly different starting conditions. Namely, while in Bohemia the industrial basis had already been built up before World War II. (i.e. prior to the establishment of the CMEA), Slovak industry developed expressly in accordance with the demand of integration and specialization within the CMEA. This is the reason why the transformation of foreign trade and, in general, of economic structure, can be implemented with relatively lower sacrifices in Bohemia than in Slovakia. In Svejnar's opinion the differing unemployment indicators of the two countries are also a consequence of the aforementioned factor (pp. 48–49).

However, Valtr Komárek, contrary to Svejnar, judges the Czecho-Slovak transformation in an extremely critical light and sees it in basically negative terms. He sets out not from the results of stabilization but from the declining performance of the economy, and he paints a very dismal picture of the future of both countries. The main arguments and conditions for the transformation all point to the fact that it ought to be implemented at a much slower rate, starting out from, and adjusting to, the existing potentialities of the institutional framework.

Komárek, on the one hand, belittles or does not even mention those results which the new economic policies have been able, even if only temporarily, to achieve (e.g. in stopping the growth of inflation or unemployment). On the other hand, with regard to the gradual transition, he expounds a rather confused standpoint. Among other things, for instance, he refers to the decades of the Hungarian reform, which were "necessary" conditions, enabling the transition in Hungary to be carried out with relatively fewer shocks. At the same time he forgets that the Hungarian reformers themselves attributed the lack of success of their reforms to their piecemeal implementation and insufficiently radical character.

There is no doubt that the Hungarian attempts at economic reform greatly contributed to a strengthening of flexibility and adaptability, as well as the enhancement of the managerial abilities of many participants of the economy. In other words, this implies that since the collapse of the socialist system, and despite the high speed of the economic transformation and the incalculable risks and losses, the majority of the Hungarian companies, economic units and entrepreneurs have been able to survive and adjust themselves to the new economic conditions. Yet, these advantages have not been enough for the Hungarian economy to become a market economy; in fact, even under the conditions of socialism the reforms were unable to improve allocative and productive efficiencies. Taken together, the economic reforms were unable to reach the objectives set by the political and economic management. However—and mainly as an unintended by-product—the reforms have produced such groups of employees, company managers, private entrepreneurs and government of-

ficials who—once the adequate legal and institutional frameworks had been created—were relatively quickly able to change over to the mode of operation of the market economy. These people have also been able to maintain operation of the economy, despite the continuation of poor economic political management and control.

Komárek, however, makes a mistake or distorts the facts if he thinks that the Hungarian reforms have been able to bring into being the institutional system of a market economy. It would be a serious error if the Czech and Slovak economic or political leaders were to make attempts at solutions similar to the Hungarian reforms. In any case, the prevailing conditions and time available do not allow for such an option. On the other hand, he is right—or would be right, had he clearly expounded it—in that tight monetary and fiscal policies, a devaluation of the currency, and free privatization in themselves do not create the frameworks of a market economy. In order to achieve the latter, considerable efforts are needed at building up institutions, and restructuring on the micro- and macro-level. Such processes, however, cannot be carried out within a short time.

Rosati in his critical analysis of the Polish transformation has, in my opinion, chosen a better solution than Komárek has in his examination of the Czech and Slovak transition. Rosati judges the Polish transition not from outside, as if it occupies a position outside the system, but from the "inside". In other words, he approaches the Polish economy not as an imagined one, but as one which is really operating. Hence, he tries to identify the possibilities that have been missed by the decision-makers, and where bad decisions have been made. His analyses point out that the initial steps of the Balcerowicz-programme, in the over-devaluation of the currency and in delaying the establishment of the legal and institutional frameworks of the market economy, have greatly contributed to the development of a more serious than expected economic recession, as well as unemployment. Even with regard to the future, Rosati is not too optimistic, since he does not see any reliable interest groups, political leaders, or conditions of political stability that could elaborate and, more important, help to implement a rational economic policy.

Another strong point of Rosati's analysis is that he does not subordinate everything to the growth rate of the economy. The placing of too much emphasis on the growth rate is a phenomenon that has occurred from time to time in all East European countries. In Hungary, for instance, in the late 1970s and early 1980s, a debate took place on the question of whether the growth rate of the GDP really is an important indicator of economic development. Then and ever since several economists have expounded that the system of economic policy objectives need not necessarily be initiated and determined by the growth rate. This is especially true in the case of economies in the process of transformation or forced radical restructuring. The sort of transformation of the economic micro- and macro-structures that calls for economic management and control which is much more efficient than the one experienced earlier, may take place even beside a relatively slow growth rate. Still, the fetish of growth rate, time and again, appears in the standpoints of governments and their critics, too.

Contrary to Rosati, Stanislaw Gomulka draws a more favourable picture of Polish economic transition. With his usual high standards and thoroughness he excellently describes the main events of the Polish changes throughout the period 1990–92. However, he does not provide a really deep analysis.

Finally, it is worth mentioning briefly that both analyses on Hungary look very critically at the past three years, although they do it from differing points of view. While Antal and Riecke consider the increasingly serious situation of public finances to be one of the main problems and a danger for the future, Mizsei regards the rightward shift of the political forces backing the government to be a serious danger. However, Mizsei gives a positive evaluation of the performance of Hungarian economy.

Though the approaches followed by the two essays are different, there is some overlapping of a factual and chronological nature. Thus they both certainly contain a lot of new information for the foreign reader, and their views are by no means in diametrical contradiction

to one another. From Mizsei's political analysis it logically follows that the measures needed in economic policy are not likely to come about if, in the meantime, the government and its political bases are more and more engaged in irrational political disputes. The conclusions of Antal and Riecke on the tensions of monetary and fiscal processes and policies to a certain extent reflect what is formulated by Mizsei. They also point out the increasing disarrangement of the government and its basis.

It is, of course, impossible in a brief review, to take into account the strength and weakness of every statement in a volume dealing with East Central European transformation; we might not be fully satisfied with the depth of analyses and the pragmatical nature of the research in the volume. Nevertheless, it is a merit and advantage that, compared with the fashionable, economic-political literature which offers advice concealed in analitical forms, it strives to devote the greatest possible publicity to the facts, and yet is reluctant to advertise remedies for all ills. This volume of essays and studies is rich in data and well-arranged tables, and may help to promote further research.

I. MAJOR

van BRABANT, J. M.: *Privatizing Eastern Europe. The role of markets and ownership in the transition.* International Studies in Economics and Econometrics; Vol. 24. Dordrecht–Boston–London: Kluwer Academic Publishers. xiv+327 p.

Jozef M. *van Brabant* has for decades followed, with intense interest, economic developments in the Eastern European countries (socialist in the past, post-socialist at present). He has also paid particularly close attention to the transformation of their institutional system. His work has largely contributed to the theoretical framework necessary for understanding and evaluating these processes, for the formulation of relevant theoretical statements, and for useful policy lessons and suggestions. His studies have centred upon some very important aspects of the commercial, economic and financial integration of the (then) CMEA countries. In order to make the foreign trade implications of the Eastern European political and economic turnaround manageable, in 1989–90 he published a highly appreciated suggestion about a possible payment union of the CMEA countries. The suggestion was espoused by several international organisations (first of all by the Economic Committee of Europe of the UNO), and modified versions of the original idea regularly reappear in the literature of "transitology"—even if its practical implementation has never been put on the agenda due to lack of political will and sufficient finances.

The author has, throughout his career, had an affinity to the more general "political economy" questions of (post-) socialist countries. Within this sphere are included property relations, which are held by many to comprise one of the most (or even *the* most) important elements of the situation. The book reviewed here is the culmination and the summary of this research. It is a monumental work based on a wide literature, and it tries to sketch an overall picture of the theoretical background to the transformation of property relations, the policy problems, the privatization techniques used, and the actual state of the process. The book, which was published in 1992, starts with the characteristics and development of central planning (defining thereby the economic and institutional framework left to "transformators" by socialist planning). Then comes a comparative analysis of plan and market coordination, the interpretation of the economic role of the government, the interrelationship between property rights and market (economy), the role of capital markets in resource allocation and the necessity of their organic development in order to eventually arrive at the objectives, obstacles, tools, techniques and the present state of privatization in post-socialist countries.

The range of the outlook is manifested not only by the diversity of topics treated, but also by the number of countries figuring in the part dealing with actual developments of the privatization process. The author has so much information on all the coun-

tries experimenting with transition to a market economy that he is able to present (in a few pages or paragraphs) goals for all of them. This includes details of main tools used as well as the results of privatization (the latter measured by the number of privatized firms, or the contribution of the private sector to GDP). Thus the reader cannot only refresh his knowledge about privatization in Eastern-Central-Europe and the post-Soviet states as part of a theoretical framework, but he also gets the basic facts about the methods and problems of privatization—e.g. in Albania, Mongolia or Cambodia.

The process of changing the proprietor is relegated by the author to the realm of political economy. The approach and methods of investigation of the latter are held to be the most suitable for describing and evaluating government actions. These actions are fraught with many uncertainties, decisions and practical considerations which are contradictory from a professional point of view. Nevertheless, in their entirety they constitute the privatization campaign. The latter is, in the opinion of the author, an integral part of the politics of transition, since its immediate aim is the efficient use of state property. Also, in the final account, it involves the maintenance and strengthening of the social-political acceptance of, and backing for, the transformation process.

Van Brabant—like other authors who have for a long period of time dealt with the functioning of the former planned economies—disagrees with certain theoretical and practical problems raised by some transitologists. Without a deeper knowledge of the special characteristics of socialist economies these suddenly apparent transitologists have jumped onto the band-wagon of transitology and gained prominence in the recent past both in the area of theoretical approaches and in economic policy suggestions. The whole book polemicizes with the assumptions, statements and suggestions of this latter school (its main figures being Rudiger *Dornbusch*, Stanley *Fischer*, Jeffrey *Sachs* and several specialists of the World Bank). The debate is partly hidden but is open in some places (e.g. where Brabant writes: "Particularly those new to the problems of the East" (p. 184); argue wrongly about the value of capital goods in transition economies).

The main difference between these points of view is probably not unknown to the reader. With a certain simplification this is the debate between the adherents of radical transition (sometimes—perhaps wrongly—called "shock" therapy), and the adherents of gradualism. In the words of van Brabant: "The drift of the discussions about economic policy in particular since mid-1989 has continued to swell in favor of a new orthodoxy that advocated the myth of a natural order emerging in full glory—including stability, prosperity and welfare—as soon as the shackles of public ownership and state regulation are removed. This new ideology is potent. Yet is jeopardizes the future of the East." (p. 94)

Independent of our judgement about the validity of the above statement we have to acknowledge that the author substantiates his point of view, i.e. the superiority of a well-considered, gradual approach, with an important role for government intervention, and keeping the process within certain confines. He does this by relying on a vast literature, by assembling all the arguments for and against, and by pursuing a detailed (sometimes recurring) train of thought. In his arguments concerning privatization, a key role is given to the main conclusions of works that summarize the experiences of privatization over the last two decades in developed market economies and in developing countries. An important statement connected with the above is that "market failures ... are notorious when it comes to monitoring corporations, particularly when the regulatory, legal and financial infrastructures are in statu nascendi." (p. 284)

This latter circumstance alone makes it imperative to reconsider the view—dominant according to van Brabant—about the inappropriateness of the role of government. In the case of privatization this implies that the goal of rapid privatization, accelerated by special means, should be abandoned and the long-term activity and functions of the state sector in the economy in transition be rethought and redefined. After a deep study of the literature van Brabant summarizes the lessons of the world-wide process of privatization, as well as the conclusions of investigations into performance of

state and private firms, and pre- and postprivatization situations; he writes "The allocative and productive efficiency implications of property assignments depend very much on the competitive and regulatory environment in which economic agents operate, with the latter two typically having substantially larger effects on company performance than ownership per se." Although the author has thus tried to formulate "an element of skepticism into the desirability of fast and widespread divestment" (p. 282) the title of the last subdivision of the book is emblematic: "Is privatization desirable?". The reviewer has to call attention to the fact that the quarterly publication of the London-based European Bank for Reconstruction and Development has recently published (in a concise and well-structured form) Edmund Phelps' arguments for private property.[6] Among Phelps' arguments there are some that do not figure in van Brabant's book. (Let me mention here only the efficiency of—proprietory—control over firms or the synergy effects of the property structure.)

Beyond the theoretical (we might say near religious) debate concerning economic policies for transition and the property structure let me single out two further questions van Brabant inadvertently raises. One is his view about restitution, which is tightly connected to his notion about "political economy". Departing from the assumption that in economies in transition there is a morally-based consensus about the necessity to restitute the victims of nationalisation, the author does not challenge the necessity or desirability of restitution. He only prefers one of its possible forms over another. In his opinion compensation with money or restitution vouchers is less dangerous for an underdeveloped legal infrastructure and the security of property rights than (physical) reprivatization. In this respect the Hungarian practice is the best among those actually used in economies in transition, although even in Hungary there are unsolved problems (e.g. estates of the churches and of foundations, the problems of agriculture).

With regard to control over firms to be privatized (sooner or later) and those forms that should remain in state property, van Brabant proposes two institutions—both under the control of Parliament. One of these institutions would be similar to the Hungarian State Property Agency, and its tasks would be to abolish the power of the former nomenklatura in state firms and to incorporate those firms. Beyond that, in case of firms to be privatized (in the period before privatization) and in case of the majority of firms remaining in state ownership, the transitory or long-term state proprietor would have to formulate requirements such that the new management would face a situation which makes their "budget constraints hard" (the latter is referred to by the author as "commercialization"). Unfortunately van Brabant does not go into detail about the methods to be used for putting firms that are to remain in long-term state ownership under the same efficiency and profitability constraints as private firms. He thinks, however, that even if the proprietory control is not as efficient as private firms it might still be enough to nullify the urge to sell state property or prevent its loss of value. The author thinks a guarantee can be created against efficiency-stifling bureaucracies by putting organs representing the proprietory interests of the state under Parliamentary control, by filling managerial posts on a rotation system, and by forming a collateral with managers of private property. In this way the resource allocation of state property would be improved and certainly not worsened.

Although the practical privatization experiences that have been gained since the publication of the book render some of the author's suggestions as wrong and/or unrealistic, it is certain that van Brabant's snapshot on the bumpy road of East-European privatization is a work rich in new ideas. These are worthy of careful consideration and they make the book indispensable for all those who are interested in theoretical and historical approaches.

L. G. TÓTH

[6] Arguments for private ownership, EBRD Economic Review, September 1993, pp. 113–132.

SWAAN, W.: *Behaviour and institutions under economic reform. Price regulation and market behaviour in Hungary.* Tinbergen Research Series, No. 40. Amsterdam: Thesis Publishers. 1993. 358 p.

It happens only rarely that we learn from a foreign author something about our own country's economy that has not yet been publicised by a Hungarian economist. This book by the Dutch author Wim Swaan is, besides its other virtues, worth reviewing here just because of that. It was originally a doctoral thesis submitted to and defended at the University of Amsterdam. Consequently, its structure, division of chapters and even the composition of the individual chapters conform with the relevant criteria for such a piece of work, and it also accounts for the text being somewhat lengthy. The book consists of eight chapters, of which six form its core and deal with four major issues: first, the source and motivation behind the method of research chosen by the author, and termed by him (a little ponderously) "behavioural-institutional"; second, a description of the price regulation of the 1980s (based on the author's own research and containing many new facts), as well as the regulation's emergence in the life of enterprises; third, an attempt to show the economic power of a formation referred to as the "party-state hierarchy" dwindled away (this was based on available literature and on interviews made with top managers of five large Hungarian companies); and fourth, two interrelated and comparative studies on the economic behaviour of Polish and Hungarian companies in the 1980s and at the beginning of the economic transition period, i.e. 1989/90 (these latter studies rely on research done jointly with Maria *Lissowska* of Poland). This review has focussed on the parts that, owing to their academic relevance, originality and/or novelty rise above the surface of the fairly salty sea of literature on reform economies and on those in transition.

Due to the obligatory structure of the thesis, in Chapter II Wim Swaan surprises us with a remarkable little essay on the methodology of scientific research or, more exactly, on that of economic research. His appealing starting point is the term "research programme" as devised by Imre *Lakatos*. Here it means no more than research workers keeping in more or less close touch with each other and reaching a sort of explicit or tacit understanding with regard to what is worth researching and how. The concept is likable since it does not forget to include cognition in science, and the need for the researcher's curiosity when carrying out research; it does not urge anyone to hunt for more and more new paradigms ("Can you spare a paradigm?" was the ironic title of an article in the New Scientist in the 1980s) and it frees the researcher from the autocracy of even the most fashionable discourse, while not preventing him or her from opting for a paradigm or discourse. As for the dominant paradigm, the era of convergence theories in economic science came to an end in the early 1980s: it was generally accepted that the economies of countries calling themselves planned economies or socialist (at one time or another this included the economies of twenty to twenty-five developing or less developed countries) and those of countries considered to have market economies (twenty-five to thirty highly developed and less developed countries) had to be studied using radically different theories. With regard to the first group, the most respected theory is that of János *Kornai*, while for the second one a version or ramification of neo-classical theories is usually applied. (Ever since the motive for "closing up" was erased from development theories, no generally accepted new theory applicable to the economies of the ten to twelve dozens of "in-between" countries has emerged.)

The dominant discourse has been that which adopts a few basic notions of both theories, using mostly IMF phraseology; thus it tends to centre upon the macro-economy and is, sadly, technicist. Wim Swaan accepts both paradigm and discourse yet, as he reveals, in the early 1980, while still an undergraduate, he learned about a more down-to-earth research programme. The scholars who had used this programme had primarily been interested in the working of an economy from the aspects of the interrelations and interactions of an economy's institutions and players. The author underlines two important fea-

tures of this approach. According to the first, scholars cannot content themselves with simply stating that the economy being studied corresponds, or does not correspond to some generally accepted theoretical model ("negative analysis"). Instead they have to study and describe it "on its own merits". He calls this approach "appreciative", and another of its basic features is that the value of, or results gained by using, the appreciative theory will not necessarily be decided by the fact that a formalized theory, measurable in terms of the natural sciences, can be created from them or not. The main method applied is notably that of field studies or case studies. The summary and generalization of facts (often falling within the scope of sociology) and stories (often based on hearsay) are rather a matter of feeling and empathy, and do not depend on the results of logical deduction. Hence Swaan had to defend the standpoint in his dissertation most carefully. In so doing, he seems to have successfully referred to the behavioural school of Herbert Simon and to the theory of new institutionalism that could have rather been referred to as new political economy. In this way the author has declared that he has joined a seemingly important but up until now insufficiently appreciated branch of twenty-five, or even forty years of research work done in Hungary; this cannot be called empiric research, because the term "empiric" is usually reserved for a branch of mathematical economics. With regard to this, the author does not differentiate between genuine case studies, and articles and books that tend to make generalizations. It is partly due to this fact that obvious differences in opinion, method, technique and the conclusions of the Hungarian authors profusely cited, as well as debates fought by and around them, have not been dealt with in the thesis.

The next chapter looks at the operation and effects of the so-called "competitive price system". Among the Hungarian economic reforms of recent decades, there were genuine ones that helped to loosen the dependency of enterprises on the state and its authorities, and enabled them to enter new forms of relationships; such was the reform of 1968. It is true that there were artificial and fake reforms that merely simplified the work of the authorities or enhanced their importance. Of the latter kind, the most deceptive one was the aforementioned competitive price system that kept on damaging the Hungarian economy from 1980 until 1987. The sum of that system was that enterprises of the processing industry were allowed to raise their domestic prices (disregarding import prices, supply and demand and even the level of prices) and/or to add to their profits to the extent they were able to raise their prices and profits from exports to the West. Enterprises that had no export business had to adopt prices achieved by others that were involved in exporting. Of course, this is no way to form prices. Once the system was introduced exports began to fall and ties between companies soon broke off. Meanwhile the National Office for Materials and Prices (OAÁH) came to dominate the market. However, in 1987 the government abandoned the system and let enterprises form their prices; even so, as recently as 1989 the OAÁH managed to exercise the right to overrule intentions to raise a price and to impose fines whenever it thought it could detect a so-called "unfair price". Strange as it may seem, no other Hungarian reform has ever attracted so much interest abroad as this abortive one; in the West the OAÁH boasted that in Hungary world market prices were the rule, and when in Moscow OAÁH experts boasted that they could control prices much better than most of their colleagues in the East. Hungarian analyses of the issue are rather scarce. However, Wim Swaan has compiled an imposing set of statistics on what price regulations actually existed and how long they were in effect for the individual branches. Also he is the first researcher to take the OAÁH's bulletins for the years 1987–89 and to write out and group the results (e.g. motives behind the approval or prohibition of price hikes) of price consultations arranged by the Price Office. Wim Swaan's studies are the only source of data on this subject. (It is a great pity that only a fragment of these have been published in Hungarian, notably a brief article in the 1990/4 issue of the periodical *Gazdasági Fórum*.) He interviewed 50 CEOs and questioned them on several more economic policy instruments, such as the abolition of subsidies, monetary restrictions and the behaviour of enterprises. He is one

of the few people who is aware of the fact that in 1986/87 Hungarian enterprises were complaining of diminishing domestic demand (while specialists at home and abroad were at the time busily discoursing on how very comfortable the market position of Hungarian companies was).

The third chapter focusses on various groups of Hungarian enterprises, including large ones, that from the mid-1980s onwards displayed some form of market-oriented economic behaviour. Surprisingly, Wim Swaan treats this as a brand new phenomena, whereas the changes in the years 1968/70 had been much more radical than in the mid-1980s. In the years 1968/70 enterprises were not only getting no production plan instructions but they were forced to organize, or at least strengthen, their ties to the buyer/seller. In other words, they had to create a market (however weak or shaky it was) in the place of a rigid and centralised system of product distribution. (The secrets of creating a market have always been preparation and support.) It is true that scholars who sympathized with the reform and were disappointed at its interruption and partial withdrawal eventually came to represent the view that no real change had taken place in the operation of the economy since 1968, and that it was merely the method of management that had been changed (i.e. indirect plan instructions). This was a convenient position for those opposed to the reform, or for those who had to apologize to Moscow; after all, this was the thesis closest to the emerging new perception of the reform in the West. Yet this misapprehension on the part of the author has the unpleasant consequence that he keeps on returning to possible causes of an ostensibly delayed effect of the 1968 reform, and he eventually devises a whole theory around them. On the other hand, it is important and relevant that he draws attention to the renewal of interference of party organs in company matters (sometimes in new forms) during the first half of the 1970s, and that the disintegration of structures that had been created in this way had already begun in Hungary in the 1980s. It is still an open question as to the role the spectacular redistribution of ownership rights (dismembering of enterprises, the role of company councils, industrial firms becoming part-owners in investment funds and later, in banks) played in this process.

Unfortunately, the two chapters comparing Poland and Hungary are dominated by pure speculation. An article on the subject by Wim Swaan and Maria Lissowska was published in Hungarian in the 1994 No. 2 issue of the periodical *Külgazdaság*. In this article the authors discuss the restrictions geared to stabilize the market, market conditions and liberalization, and deregulation and legal institutions necessary for capitalism, and the way these provoked the "supply answer" from Polish and Hungarian enterprises. Swaan and Lissowska found a weak and sometimes paradoxical answer that enterprises narrowed their supply and raised their prices, and that state-owned enterprises in both countries did not change—that is, they continued to be "monopolists minimizing their efforts".

From Polish sources we know that an important part of the stabilization package introduced in 1990 involved units of wholesale-distributive organizations operating within industrial associations and founded with little or no working capital; these suddenly had no more access to credits, or if they had, these were only with prohibitive interest rates. This had the result that industrial enterprises faced an abrupt change, with the disappearance of outlets to whom they could provide goods. Thus they were forced to sell their products from warehouses and from trucks standing in the street. Soon they ran out of money and stopped turning out even those products that had been in short supply anyhow. In Hungary something similar happened (only sooner) in 1987. This continued until 1992 when enterprises finally went bankrupt or had to be liquidated. The author emphasizes the bottleneck in the competency of company and state management, and thinks that in order to have achieved the expected economic results through the obligatory measures of privatization, proper market institutions and financial stabilization, much more would have been needed (p. 258). There must be some truth in this.

However, one cannot help recalling the anecdote about the biologist who researched the conditioned reflexes of a flea. As a first step, he trained a flea to jump when hearing a whis-

tle and the command "Flea, jump!" Excerpts from the research journal: "First day: removed first pair of legs of flea. 'Flea jump!' Flea jumped. Second day: removed second pair of legs of flea. Whistle. 'Flea, jump!' Flea jumped. Third day: removed third pair of legs of flea. Whistle. 'Flea jump!'. Flea went deaf."

Wim Swaan has sufficent talent both as an economist and a researcher not to feel that something is wrong here. Off and on fragments of autonomous thinking do emerge among the mass of too well known phrases of transitology: like when he suggests that one should be more careful with restrictions in an economy with embryonic wholesale trade and underdeveloped retail trade, or that recession—if artificially triggered—might set back the state sector as well as the private one (p. 259). Consequently, a stabilization package containing solely financial instruments may only make things worse rather than better if applied in an unsuitable environment (p. 260).

The citation index fills over 30 pages and, what is more important, lists mostly the cream of the literature on the subject. In Hungary, the book is available from the library of the Institute of Economics of the Hungarian Academy of Sciences.

K. LÁNYI

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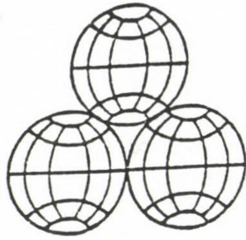

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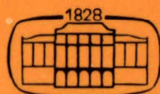

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FROM CREDIT VOUCHERS TO THE SMALL INVESTORS' SHARE-PURCHASE PROGRAMME*

I. MAJOR

Although Hungary in the last four years has seen privatization on a larger scale than it had been common in the developed market economies over recent decades, the transformation of state-owned property into private property has yet to reach a decisive stage in the Hungarian economy. Moreover, the ownership uncertainties characteristic of the whole economy have done serious harm to the value of the property and to the economy's ability to grow. Recovery from the economic recession can only be expected to come to a large extent from the growth of commercial investment, primarily private one.

Demand constraint or short supply in Hungarian privatization?

When mass privatization began in Hungary in 1989–90, the hard constraint on the process appeared to be the modest domestic demand for state assets. Net personal savings, taken as the indicator of this domestic demand, amounted to about one twentieth of the book value of state property in 1989–90, and the net savings increment in 1989 was less than 1 percent of the latter. Thus the government understandably expected mass privatization to begin with the arousal of interest among foreign investors; there still seemed to be a good chance for this in 1990, before Hungary had to face other Eastern European rivals expecting an influx of foreign capital.

Many Hungarian economists hoped that domestic private entrepreneurs could be induced to take part in privatization by offers of concessionary credit tied to asset purchases.[1] The government actually introduced such credit schemes, based mainly on foreign financial support. However, the procedures for obtaining access to the loans were extremely cumbersome, and even interest rates well below the market level exceeded the likely profitability of the assets obtained through privatization. For these reasons the concessionary credits failed to produce mass participation in privatization by domestic private entrepreneurs.

The excessive centralization and protraction of the privatization process brought about a paradoxical situation. The demand constraint on privatization would become decisive so long as the process moved along quite quickly and the State Property Agency (SPA) tried to set the selling price of the stakes in state

*This study was prepared under the programme *Legal and Regulatory Reform in Hungary* conducted by the Centre for International Private Enterprise. A grant from the National Scientific Research Foundation of Hungary also supported the project.

[1] See, for instance, *Kornai* (1989).

MAGYAR TUDOMÁNYOS AKADÉMIA KÖNYVTÁRA

assets at levels close to their book value. It soon emerged, however, that there was a considerable gap between the book value of state assets and their true market value measured as a present value and discounting their expected future returns. With offer prices set by the SPA being much higher than the market value, demand remained slack. This slack demand and the uncertainty hanging over the future of firms still awaiting privatization led to a steady devaluation of the assets. In other words, the level of the effective supply sank deeper and deeper.

Another factor eroding the value of the supply of Hungarian state property was that more and more ex-socialist countries were bringing their assets onto the international privatization market. Meanwhile the *potential* domestic demand, measured in net personal savings, increased almost tenfold in three years. So by the end of 1992, the situation was one in which the *effective* supply and demand were both at a low level; however, they still failed to balance each other out because their *structures* were incompatible. The deteriorating state of supply, coupled with the protracted economic recession and the continuing uncertainties over property rights, meant that potential investors faced risks greater than they were usually willing to take. Meanwhile both the *potential* demand and potential supply (meaning by the latter the stock of assets still on the state's hands) became very high. Moreover, the former was unable or unwilling to turn into *effective* demand, due to institutional constraints, the uncertainty of the investments, and the unfavourable economic climate and prospects. Nor did the potential supply turn into effective supply, for which it would have been necessary to make the assets marketable and their prices realistic, and enable market forms of asset management to develop.

What the situation called for was a change in privatization policy designed to increase the quantitative demand and also to alleviate the structural tensions between the supply and the demand. Yet neither the SPA nor the State Property-Management Company (SPMC—the asset-management company established in 1992) proved capable of improving the quality of the asset supply. This is not surprising for such actions could only really be expected of predominantly privately-owned asset managers operating on market lines. Another reason why real decentralization of the privatization process was and remains necessary in order to create compatibility between the supply and the demand is that this is the only way to depoliticize privatization decision-making fully and avoid a situation in which every move made by the SPA and the SPMC is determined by the prevailing state in the battle between the political interest groups.

Instead of taking this line, the government opted for seemingly radical measures patently aimed at stimulating demand artificially. One such measure was the adoption of the Small Investors' Share-Purchase (SISP) Programme on October 14 1993. (*Magyar Hírlap*, October 15, 1993) The government's intended extension of the deadline for compensation and widening of the sphere of entitlement are in the same category.

Credit vouchers, coupons and "people's" shares

It is popularly believed that Hungary has avoided the free hand-outs of state assets used in the other ex-socialist countries of Eastern Europe, but this is only partly true. The whole compensation process (which Hungary preceded all other former socialist countries in introducing) can be classed as free distribution, as can the return on nationalized church assets and the transfer of assets to the social-insurance fund.

The SISP Programme, established in 1992 and launched in the autumn of 1993, is not without antecedents. The idea of a broad free hand-out of assets can be traced back to Tibor *Liska*'s "people's shareholding model". A scheme very similar to the one introduced in 1993 was put forward in a specific form in 1990 when István *Síklaky*, also responsible for reviving the idea of credit vouchers, wrote as follows about the "lay-man protection programme" devised by the Ownership Reform Workshop:

> "The lay-man protection programme recommended implementing citizen's shares in such a way that *every citizen* would receive a share-purchase voucher of equal value to buy shares in the state-owned firms compulsorily converted into public companies, to a value such that the sum of all these vouchers would suffice to buy the shares issued in a particular phase. This is the way to distribute *half* of the assets of state-owned firms, which are estimated to be worth a total of HUF 2–3 trillion... This solution is developed in the proposal put forward by Lajos Bokros (published in *Népszabadság* on October 27, 1990) in the following way. Instead of being received by every citizen, the share-purchase quota would go to every citizen who had pursued a *paid occupation* in the previous period." (Síklaky 1990). The emphases are in the original.

Numerous features of this idea can be seen in the government's SISP plan as well. The main differences are that citizens' shares will be used to break up state ownership to a far smaller extent than Síklaky recommended, and that the Síklaky proposal did not envisage an obligation to repay the value of the shares, while the citizens' share quota under SISP is considered a loan, and although it is interest-free, it has to be repaid.

The opposition Alliance of Free Democrats also came forward in the first half of 1990 with a proposal for free distribution of assets on a limited scale. The Alliance's economic policy-makers at the time presented the free asset voucher (Hungarian citizens would have received vouchers to a value of HUF 20,000 per head) as an extension of the compensation process, under which all citizens would have been "compensated" for the trials of the previous 40 years. The idea, however, was sharply rejected, primarily by the government and coalition parties, and from then until mid-1992, the idea of a free distribution of assets was hardly mentioned at all.

Economists were also surprised in the autumn of 1992 when news began to leak out from government circles about preparations for a large-scale programme of free asset distribution. The news could not be confirmed, because the leading

and subordinate state officials involved in the work maintained a strict silence. Thus for the most part it is only possible to reconstruct after the event what considerations must have persuaded the government to re-examine its previous policy on privatization and decide to make a change.

It was mentioned earlier that the main obstacle to faster privatization still seemed in 1990–91 to be the meagre privatization demand. Although this was no longer the case in 1992, there was something reminiscent of "shortage-economy delay" (*Soós* 1986) in the fact that almost a year elapsed between the identification of the problem and the economic-policy decision.

In the same period, the intention of speeding privatization up by governmental means also lay behind the economic-recovery programme devised by a working group directed by Tamás Szabó, minister without portfolio. Another factor was a change in the estimation of foreign direct investment among those in and around the government, where the opinion was increasingly that foreign investors had gained too much of the Hungarian state's property too cheaply. An important criterion for those who devised SISP or its predecessor, the concept of credit vouchers, was that the proportions within privatization should shift in favour of Hungarian private owners, who had less capital. They saw a central solution to this in as broad a group of Hungarian owners as possible receiving part of the state's property virtually free of charge.

This objective also seemed to be supported by the fact that state assets were steadily losing value on the market. The market value of more and more firms was falling to zero or even becoming negative. So if the market value of the firms was next to nothing in any case, it no longer seemed senseless to transfer some of the assets at a price next to nothing.

The decision-makers were probably influenced by the unexpected success in the *Czech and Slovak Republic* of the first phase of mass free privatization, conducted by citizens subscribing for coupons. According to observers, the initial success of coupon privatization also contributed to the victory of Vaclav Klaus and his party at the polls, and this circumstance made a deep impression on a Hungarian government that was increasingly unpopular at a time when the next general elections were approaching.

In the summer of 1992, two committees were set up to devise the technique for almost-free privatization. One, the "strategic committee", was to examine the preliminary political and important economic questions, while the other, "technical committee", was to work out the details of the privatization technique. The strategic committee contained high-ranking representatives (state secretaries or vice-presidents) of the various economic ministries and state administrative bodies and of the National Bank of Hungary. The technical committee consisted in the main of executive-council members and senior officials of the SPA, along with a few business people and independent experts.

The strategic and technical committees first of all devised a concept for "privatization credit vouchers" and "privatization letters of credit". The original idea was for the credit voucher to give an entitlement to borrow up to HUF 1 million, while no maximum value was put on the letter of credit. However, the idea of the latter was soon forgotten and attention confined to the credit voucher.[2]

The credit-voucher concept was based on the initial assumptions that privatization demand was short and that the state made a worse owner than *any* private owner. So the devisers of the scheme wanted to speed up the privatization and were accordingly prepared to create demand even by artificial means. The purpose was to be served by the credit vouchers, which would be made widely accessible.

A credit voucher was to be a money substitute with a face value of HUF 1 million, whose holder could use it to purchase state assets, but for no other purpose. The holder of the credit embodied in the credit voucher would have had to pay it back with interest. It was envisaged that there would be a five-year grace period followed by a ten-year repayment period, and that the interest rate would be a very low 10 percent. The credit voucher would have been non-negotiable, but the devisers of the scheme wanted to make it possible for several holders of credit vouchers to pool them in order to buy a firm or a share in a firm. The property acquired would have acted as security until the whole principal and interest had been repaid.

Initially the idea was for credit vouchers to be accessible to any adult Hungarian citizen, but it was soon realized that if some 8 million adult citizens really took advantage of the scheme, HUF 8 trillions' worth of free state assets would be needed. Therefore the technical committee recommended that access to the credit vouchers should only be gained at auction, the commodity auctioned being the repayment term undertaken by the bidder. Having obtained the credit voucher, its holder would then have had to bid again for the asset he or she wished to acquire.

The credit-voucher concept was strongly attacked by the Finance Ministry before it was published. (*Magyar Hírlap*, January 7, 1993) A day later came a reply to the Finance Ministry article from the cabinet chief to the minister in charge of privatization. (*Magyar Hírlap*, January 8, 1993) However, the duel between insiders was still not followed by publication of the ideas concerned.

A few people managed to obtain some information in spite of this secretiveness, and the credit-voucher concept was strongly criticized in the press.[3] The essence of the criticisms can be summed up like this. The credit voucher appears to be a way of obtaining property for next to nothing, but if the small investors

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[2]The outline concept for credit-voucher privatization is described here on the basis of documents prepared by the technical committee: *Hiteljegyes privatizáció (HP) koncepciója (tervezet)* (Concept for Credit-Voucher Privatization [draft]), and *Hiteljegyes privatizáció (HP) koncepciója (B változat), 1992. augusztus* (Concept for Credit-Voucher Privatization [Version B], August 1992).

[3]See, for example, Zs. G. 1993; Jaksity 1993a; Riecke 1993; Major 1993.

taking up the opportunity lack a significant amount of extra capital that they can invest in the property they have acquired (which is the case with most of the Hungarian citizens targeted in the concept), the loan instalments and interest will place such a burden on the new owners that they will either have to return the property acquired—thus losing the instalments already paid—or dispose of the saleable parts of it in some other way. This is the only way small investors will be able to pay the debt off, but it means the assets are simply being consumed, not utilized in a profitable way.

Since not all adult citizens would be able to acquire property under the scheme, some critics also attacked it for leaving the way open for selecting recipients on curious, even politically motivated grounds. Even with only a limited number of recipients, it would be very difficult to avoid compiling a package of state assets that consisted exclusively of run-down firms.

The authors of the concept soon departed from their original ideas. For a short while it looked as if there might be a swing towards the kind of voucher privatization employed in the Czech Republic. Then came a new turn of events. The SPA drew into the process of devising privatization techniques the British consultancy firm Schroeders, which came up with the old-new idea of "citizens' shares".

The SISP plan ostensibly took the experts' earlier criticisms into account. The credit entitlements would be for HUF 100,000 instead of HUF 1 million, and there would be no interest to pay. The term was to be five years, and the credit accessible to anyone paying a registration fee of HUF 2,000. However, it remains questionable whether everyone will be able to obtain company shares for their credit, because the supply of assets is even shorter than it seemed at the beginning of 1993. (*Népszabadság*, April 16, 1993) Although SISP did not elicit such strong reactions as its predecessor, there were some critical analyses of it. György Jaksity, for instance, pointed out that the programme would be very expensive to carry out, yet fail to solve the main problem of the state's property—efficient utilization, and also its reorganization. (Jaksity 1993b)

An essential difference from the earlier concepts was that the privatization credit would only be exchangeable for *shares* listed on the stock exchange, not for physical assets. Under SISP, the small investors would be allowed to obtain a total share of 5–15 percent in each firm. The SPA, in fact, was still trying to ensure a predominant role for trade and/or financial investors even in the firms included in the SISP scheme. According to a summary by the SPA director responsible, the essence of the programme can be described as follows:

The purpose of the SISP programme, like its predecessor, is to speed up the privatization of state assets, and also to allow wide sections of the population to take part in it. The credit-voucher scheme did not identify a "target group"; an interesting new feature of the SISP plan is that it contains a "sub-system" (and

a scheme for paying in instalments) expressly designed to back up investment by recipients of compensation.

The share-purchase credit facility of HUF 100,000 offered by the state under the SISP scheme can be drawn upon by any Hungarian citizen over the age of 18 who is permanently resident in Hungary. The credit can only be used for buying the shares in state assets offered for SISP purposes. The holder of the credit facility does not risk his or her own property.

The credit, which is interest-free, must be paid back in five years, although there are ways to speed up the repayments as well.

An important feature of the programme is that dividends paid on shares obtained with the credit are used to offset the repayment obligation, instead of being paid to the shareholder. However, it is unclear whether, if the dividend exceeds the repayment obligation at the time, the shareholder must in effect make an early repayment on the loan. Nor is it quite clear what happens in the opposite case, when the dividends paid fall short of the loan repayments due. In principle holders could then hand their shares back to the state, or make the repayment out of their own pockets on the assumption that the value of the shares would rise later. It can certainly be stated that the prices of shares bought under the SISP scheme will be distorted, because the shares cannot be traded until the loan has been completely repaid.

The SISP concept is an attempt to link the system of privatization credit with involvement in the privatization process of about one million people who have received compensation vouchers due to their legal entitlement to compensation. So the first batch of state property awaiting privatization and earmarked for SISP will be offered to the compensation recipients. However, the price of the shares bought with rights of compensation cannot be repaid in instalments. They must be paid for in one sum with compensation vouchers. Nevertheless, the compensation recipients are also entitled to the loan facility of HUF 100,000, the instalments on which may then be repaid with compensation vouchers. This the government hopes will stimulate the hitherto slack privatization demand from compensation recipients, and have a knock-on effect on other buyers of shares. A further expectation from the programme is that the link between SISP and compensation will in some way encourage personal savings to shift towards privatization.

Adult Hungarian citizens will be able to join the scheme on paying a registration fee of HUF 2,000 (perhaps HUF 1,000). Again, those receiving compensation in their own right will have an advantage, being exempt from the registration fee. The SPA and SPMC want to form a separate system of institutions to run the SISP scheme, although it would also handle and monitor the use of compensation vouchers in privatization. This system of institutions is likely to coincide with the chain of regional offices the SPA wants to set up in the near future, although that remains only a supposition for the time being, as the programme approved by the government makes a reference to the SISP scheme being run by the system of com-

pensation organizations—the regional compensation offices, in fact. According to the SPA, no funding from the state budget will be required to implement the SISP programme, which will be self-financing, its expenses largely being covered by the registration fees and presumably the credit instalments. It is worth adding here that the idea (when the scheme was still at the credit-voucher phase) was to entrust the running of it to some bank or financial institution. The likeliest candidate at the time seemed to be the Postabank, which the SPA experts argued has a national branch network (like that of the OTP, the National Savings Bank).

The government expects some 500,000 to 1 million SISP shareholders to joint the original holders of compensation vouchers in the next five years. The devisers of the programme see the problem as being on the supply side rather than the demand side. Over a five-year period, they want to put shares representing state property to a value of about HUF 120 billion on the market, and they reckon that this aggregate sum will consist of 70 commercial companies. However, other investors besides the recipients of compensation and the holders of SISP credits would be eligible to subscribe as well, and so a good deal less than HUF 120 billions' worth of property is intended for SISP credit-holders in the broad sense. The firm intention of the SPA is that the SISP-scheme shareholders should only be minority owners of the commercial companies, with the majority shareholders being investors from within the trade.

The supply problem arises from the difficulty at present in identifying HUF 120 billion worth of profitable property for inclusion in the scheme. The government's idea is to choose such firms primarily from the SPA's portfolio of successful public-service companies. However, it will take an inordinately long time to reorganize these and partially privatize them by introducing investors from within the trade concerned. Thus, in the first half of 1994, when the SISP project is supposed to begin, the supply will be compiled instead out of commercial companies belonging to the SPA, to an initial value of about HUF 5 billion.

Another feature of the SISP plan is that the SPA is to arrange some of the assets into holding companies and investment trusts before advertising them. The SPA also views the big industrial firms subjected to debt consolidation or financial reorganization as a potential source of assets. Finally, there is a desire to link SISP with ESP in some way.

Information has already appeared in the press about the companies to be included in the first package, with breweries, hotels and food-processing firms forming the decisive majority. (*Magyar Hírlap*, October 15, 1993) However, the SPA has disowned the lists which have been published, saying that the negotiations with existing, mainly foreign shareholders, trying to obtain consent for inclusion among the companies in the scheme are still continuing. For the time being, these owners are unenthusiastic about the idea.

Will SISP solve the problems of privatization?

The *professional* staff working on the credit-voucher and then the SISP concepts rightly saw that with the privatization process taking place in Hungary in 1990–94 and the privatization techniques being employed, the process of dismantling the system of state ownership would not be completed by the end of the century. One can also agree with the premise that the state cannot be a satisfactory owner of the property in the longer term—and here a few years already count as the longer term. However, at this juncture the search for a solution went off in the wrong direction. The reason could be that the concept of quasi-free privatization was a technical response made to a firm political order, not the outcome of professional analysis and groundwork. It is also possible that the SPA, like the economists' profession as a whole, has relatively little systematic, reliable information about the experience with privatization so far and the causes underlying the processes. Yet for whatever reason, it can certainly be said that the SISP concept fails to provide a clear response to two fundamental questions:

(1) The steady loss of value and general deterioration of state assets awaiting privatization derives from *decision-making uncertainty* in the commercial companies affected, this uncertainty being connected with the method and pace of privatization so far. Although the phenomenon has not been systematically analysed, it can be observed that in firms which are candidates for privatization, the investment activity is extremely restrained, the product structure and technology do not undergo transformation, and new marketing and management methods are not introduced. The management's main objective is to ensure that the firm survives the period of uncertainty. According to the government's ideas, SISP will not affect firms which are in a state of crisis and are probably due for a painful process of structural change. Nor could it affect them, because the idea is to admit the small investors only where large in-trade investors have already been installed, where the small investors will not be expected to make further capital injections, and where profits can be made. (For the SISP credit to be repaid solely out of dividends in five years would require a dividend level of 20 percent. This is inconceivably high under present Hungarian circumstances.)

(2) One of the basic ambiguities in the transformation of Hungary's ownership system is that the market value of the assets awaiting privatization is very low (and steadily falling), while the volume of assets still in state hands is enormous. This mass of property cannot simply be "bulldozed" away, and that would not be a rational economic solution either. For as during the period of rehabilitation after the Second World War, this property can be rendered operable and profitable by partial reorganization and recombination of the assets and by new investment. While on the one hand it is not economically senseless to hand over this property to new owners even at zero prices, economic advantage from such transactions can be expected if the new owners are able and willing (or obliged by the terms of their

acquisition contract) to take measures of structural transformation such that the market value of the assets transferred begins to rise. However, the decisive majority of owners created by SISP are not of this kind. Of course, the possibility that private investors capable of utilizing the property will in any case take advantage of SISP cannot be excluded, except that the SISP framework itself will prevent them from doing so, because the scheme necessarily means that they can only become small investors. To obtain a controlling interest in a firm they will have to resort to the SPA's traditional types of privatization sale.

Of course it is possible the government may include in SISP companies in which a stake has already been sold to an in-trade investor and/or in which a decisive stake is to remain in state hands. The public-service companies are typical of this class. It is also possible that the eye of Schroeders, the firm cooperating in drawing up the SISP scheme, may be caught by such companies, which featured in British privatization. Yet if this happens, the privatization of the state assets for which efficient private owners are most urgently needed will not be advanced one iota.

It should be mentioned here that many Hungarian and foreign economists in the last few years have recommended various forms of free privatization for a broader or narrower range of assets. Behind every such proposal has been a desire to circumvent the gulf between supply and demand in privatization through the free distribution. It has also been proposed that the *management* of assets remaining in state ownership should be placed in private hands—not free of charge, but not at a price amounting to a substantial private investment either. (*Kék Szalag...* 1992) Some proposals for free privatization have differed from the SISP concept only in being simpler, since they have made no attempt to "marketize" a type of asset distribution that was not of a truly market nature.

In another group of proposals, the role of privately-owned asset-managing firms was singled out: the public would receive shares in these asset managers, not the shares or assets of actual hitherto state-owned companies. Thus the stress was on the transfer to commercial organizations of property now in SPA or SPMC hands. The shares held by the general public would have been given some measure of owners' control over the asset managers, not over the companies directly, which the asset managers would have controlled as owners.

The latter would have done more good than SISP, resolving directly the most pressing problems with Hungarian privatization, by ensuring the efficient employment of assets that would be hard or impossible to sell to private investors in their present form.

One frequent justification made of the techniques for free privatization (and now being advanced by the government in favour of SISP) is that broad sections of the public so far excluded from privatization are brought into an active relationship with it during the process of establishing the private-ownership system. I do not consider this criterion immaterial either, particularly at a time when the public

are showing a steadily mounting antipathy to the cases of privatization they know and the results of these. Yet people do not aspire to be the deceived "owners" of already insolvent, loss-making state-owned firms. Mass privatization cannot be expected at present to provide an influx of fresh capital into such firms, and still less can SISP (or any other, similar technique) be expected to bring them efficient management and transformation. Free privatization is not an appropriate solution for an economy in a grave and protracted recession, where the majority of the firms still in state ownership are badly run down.

So the eventual conclusion must be that SISP will not solve the major problems in Hungarian privatization because it is not a response to them. As explained before, the main problem at the end of 1993 is not the shortage of demand as such, but the incompatibility between the supply and the demand, and the deteriorated standard of the supply. What the assets in state hands need are not fabricated, "sham" owners, but efficient owners who can do more than simply use them up.

Until mid-1994 only two companies' shares were offered to the public via SISP. During the formation of the new socialist-liberal government in early summer 1994 it seemed that SISP would be abandoned and forgotten. But the privatization strategy of the new government—to be adopted by the Parliament in 1995—includes SISP as an "auxiliary method" again.

Other forms of small-scale ownership

The SPA over the years has devised and introduced several privatization techniques designed to draw small-scale, low-capital Hungarian owners into the privatization process. Of these, mention must be made of the employee share-ownership programme (ESP), the leasing-privatization process, instalment-plan privatization, and the management buy-out programme now in preparation. In fact the acquisition of property by domestic small investors is also supported by the various concessionary credit schemes and the chance of using compensation vouchers for privatization. In the same class can be put the "self-privatization" process.

The privatization techniques mentioned differ from SISP in expecting a measure of financial commitment and risk-taking from the private investors. These opportunities are open on the one hand to the owners of companies already in private hands, and on the other to the managers, and to a lesser extent, the employees of state-owned businesses awaiting privatization.

Experience shows the various methods of small-scale privatization are used in most cases by the managers of small and medium-sized state-owned firms, along with their employees, in efforts to rescue the firm and the jobs it provides. Here the methods mentioned are relatively successful, since the privatization usually leaves the assets in the hands of owners familiar with them and with the possible

ways of utilizing them. However, except for self-privatization, these privatization procedures are still at a very early stage, so there is only fragmentary information available about the experiences with them: nevertheless, this already shows them to be useful weapons in Hungarian privatization.

It is worth noting the fact that the managers of the firms have proved most capable of promoting the privatization procedures just listed. Both the government and the SPA are ambivalent in their attitude to this. Their antipathy has political motivations. The majority of the managers of state-owned firms were already in similar jobs before 1989. Thus it can be argued in principle that it would be better from the point of view of the change of political and economic system to put new professionals in charge of these firms. However, the country does not possess two sets of professional managers, such that one can replace the other. Yet if the firms really pass into private hands and the privatization takes place in a rational way, market forces will sooner or later bring about the requisite (and only the requisite) changes of personnel.

A few conclusions

Since the time the transfer of state-owned property into private hands became legal and assumed a mass scale in Hungary, there has been a debate taking place among economists and politicians about whether privatization on a mass scale in really necessary and economically rational. One group of arguments in favour of privatization is provided by the experience in the developed market economies. It is certainly a fact that the businesses operating in such market economies are to a decisive extent in private hands. Dominant private ownership (which can, of course, cover several possible forms of ownership, including institutional ones) is a prior requirement for the emergence of developed market relations.

However, the results of privatization in Hungary so far have raised doubts in many people's minds about whether the experiences of Western countries apply equally to the former socialist economies of Eastern Europe. The economic transformation of Eastern Europe is certainly a task on an unprecedented scale, differing radically from the one facing the Western market economies. Privatization in Hungary does not simply have a direct effect on ownership relations, and thus ultimately on the business results of the firms concerned; at the same time, it is privatization that can abolish the basic mechanism of the socialist economy: the system of political control of the economy. If it is correct to say the socialist economic crisis was brought on by the fact that it was politically directed, and it was the system of state ownership that served as the basis for this political control, the crisis cannot be resolved without eliminating these factors.

What the experiences with Hungarian privatization show, however, is that *not all kinds* of privatization represent an advance over state ownership. The methods of privatization by which the selection of the new private owners is made on political grounds does not produce a more efficient ownership structure than the previous one. There is a substantial improvement on this if the new owners are selected by "competition", but this competition cannot be equated with selection on the money market.

Due to the series of economic reforms that have taken place over recent decades, the Hungarian economy has a more developed system of economic institutions than most other Eastern European countries. This fact suggests that it is not so necessary to fabricate privatization methods that simulate the money market. At the same time, it must be accepted that foreign private investors and domestic company managers are well-placed to play the dominant role in Hungarian privatization. This may not be socially just, but it is still preferable to transferring the state's property to clients of the new political elite or to new owners only interested in using up the assets, or incapable of doing anything else with them.

In my view, an economy with better growth prospects and which needs to undertake mass privatization, might have room for a *limited* degree of free privatization, but only if the central criterion in these solutions is that the assets due for privatization should be utilized as efficiently as possible. The Hungarian economy's short-term prospects, however, are none too favourable. Under these circumstances free privatization, especially in forms unconnected with efficient managing of the assets, may cause grave damage and further erode an already low level of social acceptance for privatization.

Although Hungary in the last four years has seen privatization on a larger scale than in the developed market economies over recent decades, the transformation of state-owned property into private property has yet to reach a decisive stage in the Hungarian economy. Moreover, the ownership uncertainties characteristic of the whole economy have done serious harm to the value of the property and to the economy's ability to grow. Recovery from the economic recession can only be expected to come to a large extent from the growth of commercial investment, primarily private investment. Yet private investment projects cannot begin on a mass scale while the property rights remain unstable. Thus there is really a need to shorten, as much as possible, the duration of the transformation of the property rights.

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MIDWAY IN THE TRANSITION

G. KOPITS

Arguably, Hungary is now halfway in the transition from central planning to a market economy. Following an overview of structural reforms and macroeconomic developments during the past four years, the article explores the outlook for sustained growth in the medium term. The analysis—illustrated with rough quantitative estimates—suggests that fiscal and quasi-fiscal wedges in the capital and labour markets impose major impediments to investment and employment, and thus to growth. The paper outlines the tasks ahead in: bank recapitalization and enterprise restructuring; reform of government finances; and social security reform. Significant progress in these areas, supported by a macroeconomic stabilization effort, would contribute to a reduction in the wedges and to sustained growth.[1]

Hungary has in all probability gone halfway, or even beyond, in the transition from a centrally planned to a market economy. Although it would be difficult to provide hard evidence in support of this statement, it is significant that by now at least one half of GDP is produced in the private sector. Therefore, it appears justified to take stock of the major economic policy issues facing Hungary at this time. Such stocktaking is all the more timely as Hungary has reached the end of the first democratically-elected government cycle. At the same time, however, this paper is in no way intended to be an assessment of either the government or the opposition parties.

The present study seeks to review the transition experience so far and to outline the major tasks yet to be undertaken in the transition to a market economy. This retrospective as well as prospective overview is conducted assuming that the foremost *policy goal is to attain sustained economic growth within the broader effort of creating a market economy*. Thus, the paper is meant to contribute to the solution of a problem of concern to economists, politicians and the public at large in Hungary today.

[1] This article is an expanded version of a lecture delivered on February 16, 1994, at the Budapest University of Economic Sciences, under the chairmanship of Rudolf *Andorka*. The author is grateful to the discussants Ferenc *Rabár*, György *Surányi*, János *Száz*, István György *Tóth* and József *Veress* for comments. Thanks are also due to István *Hetényi*, Álmos *Kovács* and Béla *Szentpéteri* for useful suggestions. Balázs *Romhányi* provided valuable research assistance. The views expressed do not necessarily reflect those of the International Monetary Fund.

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Structural change

Among former socialist countries, Hungary was undoubtedly the best prepared for the transition to a market economy at the outset of the 1990s. As a result of two decades of reform experiments, central planning was somewhat relaxed: private enterprise was allowed to flourish within rigid limits, and a few market-oriented financial reform initiatives were launched (tax system, two-tier banking system), accompanied by limited liberalization of prices and wages. Those reform steps paved the way for the transition. Perhaps of greatest advantage for this process was a body of knowledge accumulated during the pre-transition period in market principles, institutions and practices, the absence of which is most visible in the former Soviet republics. The earlier, often conflicting reform steps, however, had also led to some undesirable side effects; in particular, individuals and enterprises are perhaps more inclined to work in the hidden economy. In addition, Hungary has inherited a large foreign debt and debt service burden. Extensive foreign borrowing did not prove a prerequisite for the earlier reform experiment; in fact, it may have only postponed a series of important reform measures.

It was against this background that, in 1990, the country embarked on the transition. The process was characterized by a gradual approach, which can be considered both its weakness and its strength. Whereas the weakness was the slow pace of the reform steps, the strength was that however slowly certain measures were designed and implemented, there were relatively few instances of retrogression.

One of the most important achievements of the transition was virtually full liberalization of prices in the commodity, labor, and capital markets, including to some extent the foreign exchange market. More specifically, after the first three years, with very few exceptions, price subsidies and regulations were abandoned, wage regulations were discontinued, and most lending and deposit rates were no longer subject to control. The exchange rate was set more flexibly and uniformly. The liberalization of prices, wages and interest rates reduced the segmentation of markets.

Having recognized the small size of the Hungarian economy and the serious distortions in resourse allocation, the authorities almost immediately opened the doors to free trade, allowing almost all economic agents to participate; quantitative restrictions were replaced with relatively low customs duties—the average nominal rate was about 13 percent in 1991—and export subsidies were drastically reduced or abolished as early as one year before the collapse of the CMEA. From the very outset of the transition, the government was intent in moving toward membership in the European Union, beginning with the trade area. In general, capital transactions were substantially liberalized, ahead of most other former socialist countries, mainly with regard to direct investment inflows, including the free repatriation of profits. But liberalization did not extend to the entire balance of payments, as not all conditions for full convertibility were in place yet. Nevertheless, external and

domestic trade liberalization was one of the most significant achievements of the transition; notably, these steps were taken before powerful interest groups could prevent them as was the case in many developing and developed economies whenever liberalization on a similar scale was attempted.

It proved to be much more difficult and complicated to design market-oriented institutions, and even more so to implement them under the circumstances. Although not always completed, important and successful measures included: creation of an independent central bank; use of market-based monetary instruments; initiation of bankruptcies, liquidations and bank consolidation; widespread privatization of the real sector; open treatment of unemployment; partial reform in the social security system, including innovations in health care. In many respects, the efforts to develop these and other market-oriented institutions deserve recognition, especially as they involved a certain degree of courage. Practical implementation, in many instances pragmatic and improvised, inevitably was subject to considerable, often well deserved, criticism. In some cases, however, the innovations were subsequently fine-tuned and improved upon.

Macroeconomic developments

The achievements of the first phase of the transition, including the transformation of the institutional system, need to be evaluated in light of macroeconomic developments over the past four years. Mostly in response to the elimination of price subsidies, the consumer price level increased at an annual rate of 38 percent by mid-1991. The underlying inflation rate was much lower, as it turned out in early 1994 when the annual increase in consumer prices fell to 17 percent, shortly after the one-time impact of the VAT rate increase of a year earlier had subsided. Meanwhile, financial liberalization was reflected in the increase of deposit rates toward positive real levels, contributing to the slowdown in the income velocity of money up to 1992 (*Table 1*). Still, it can be argued that monetary policy in general helped reduce inflation and contain the external imbalance, with the exception of late 1992 and the first half of 1993, when interest rates declined to a relatively low level in real terms[2].

As a result of restructuring, bankruptcy or privatization of state-owned enterprises, combined with the open treatment of unemployment, unemployment rose at a fast rate. In early 1993, the unemployment rate was over 13 percent. In turn, unemployment benefits, fast growing public debt (presently accounting for about 85 percent of GDP), plus market-based interest rates, contributed to the

[2] The lack of adequate data and stable money demand parameters makes impossible an unambiguous assessment of the extent to which monetary policy was contractionary or expansionary over the past four years. The emergence of arrears among enterprises and the numerous financial innovations also render such an analysis difficult.

Table 1

Hungary: selected domestic economic indicators, 1988–93

	1988	1989	1990	1991	1992	*Estimate* 1993
	(Annual change in percent, unless otherwise specified)					
National income and prices						
GDP at constant prices[8]	−0.1	0.7	−3.5	−11.9	−4.3	−2.3
Domestic expenditure at constant prices[1;8]	−0.4	−0.9	−3.1	−9.6	−6.1	10.0
GDP deflator[8]	17.5	18.8	25.7	25.4	21.7	24.2
Consumer prices (end-year)	14.8	18.1	33.4	32.2	21.6	21.1
Producer prices (end-year)	5.4	15.8	32.1	21.9	18.9	10.8
Unemployment rate (percent of labour force, end-year)	–	0.5	1.5	7.5	12.3	12.1
Money and credit[2]						
Broad money[3]	3.5	13.8	29.2	28.7	26.8	15.5
Domestic credit[3]	11.9	33.3	24.2	14.1	16.0	22.6
General government, net[3]	6.7	15.5	0.7	13.4	15.8	22.9
Enterprise sector[3]	−1.2	13.2	16.7	12.2	−0.9	−0.9
Velocity (GDP relative to end-year M2)[8]	2.35	2.44	2.30	2.12	1.95	2.00
Interest rates (annual rate, end-year)[4]						
Household deposits	13.5	13.5	19.0	25.0	16.0	13.0
Enterprise credits	18.3	22.8	32.1	35.5	28.8	25.6

[1] With personal consumption on a "territorial" basis through 1988, and a "national" basis thereafter. Personal consumption on a territorial (national) basis excludes (includes) consumption by Hungarians abroad and includes (excludes) consumption by foreigners in Hungary. Prior to 1989, the difference between consumption measured on, respectively, a territorial and a national basis, was relatively small.

[2] End-year stock. Starting with 1990, based on the 1991 banking structure.

[3] As a percent of previous end-year's stock of broad money.

[4] Interest rates on one-year maturities; bank deposit rates are shown net of withholding tax.

increase in budget expenditures. At the same time, revenues stagnated owing to enterprise restructuring, buildup of prudential reserves by commercial banks, and deficiencies in tax administration. Hence, the widening budget deficit was in large part attributable to fiscal burdens which had been previously hidden and now had come to the surface. Although the large budget deficit was not caused by swelling primary (noninterest) expenditures, the necessary corrective action to reduce the deficit failed to materialize.

Table 1

Hungary: selected domestic economic indicators, 1988–93 (continued)

	1988	1989	1990	1991	1992	*Estimate* 1993
	(As a percentage of GDP, unless otherwise specified)					
Consolidated budget						
Balance[5]	−0.8	−0.8	0.8	−4.1	−6.8	−5.4
Revenue	49.2	48.5	48.3	47.1	45.9	46.7
Expenditure	50.0	49.3	47.5	51.2	52.6	52.1
Gross public debt[6]	67.9	69.1	60.3	67.7	66.5	84.5
Gross domestic investment[7]	25.3	26.6	25.4	20.4	15.2	19.7
Gross national saving[1]	25.1	25.0	27.3	17.8	14.4	11.2

[5]Adjustments are made to both revenues and expenditures relating to the financing of local governments for comparability purposes. Coverage consists of state budget, plus Pension Fund, Health Insurance Fund, Employment Fund, Solidarity Fund, and since 1990 the State Development Institute—in accordance with IMF Government Finance Statistics classification.
[6]End-year debt of general government and of the National Bank of Hungary, consolidated for government net liabilities to the NBH.
[7]Including change in inventories.
[8]National accounts data since 1991 have been revised and are not fully comparable with those of preceding years.
Sources: Central Statistical Office, Ministry of Finance, National Bank of Hungary, and Fund staff estimates.

As regards external developments, the subsidies used to support CMEA trade had been phased out starting in 1990, followed by declining market shares and worsening terms of trade (*Table 2*). The resulting impact was offset to some extent by the sale of accumulated inventories to the non-ruble market through 1992. The erosion of these export opportunities, in 1993, was accompanied by the adverse effects of a number of exogenous developments (uncertain agricultural ownership conditions, a drought, the Yugoslav embargo, recession in western Europe), and probably same revaluation of the forint in real terms, before the latter could be corrected[3]. Domestic financial savings in the private sector became inadequate

[3]The shrinking of exports can probably be explained in part by statistical distortions. These include the marked increase in the number of participants in foreign trade, and the exclusion of free-trade zones included however in production. The corresponding 1993 data for certain Western trading partner countries (that is, their imports from Hungary) suggest some under-invoicing of Hungarian exports.

Table 2

Hungary: selected external economic indicators, 1988–93[1]

	1988	1989	1990	1991	1992	*Estimate* 1993
		(Annual change in percent, unless otherwise specified)				
External trade[2]						
Non-ruble export, f.o.b. (in U.S. dollars)[3]	16.5	5.5	15.5	16.8	8.3	−19.3
Non-ruble imports, c.i.f. (in U.S. dollars)[3]	−1.4	5.1	9.0	38.3	11.1	12.5
Non-ruble export volume[4]	8.8	4.8	10.0	12.7	0.9	−13.4
Non-ruble import volume[4]	−6.8	7.0	3.3	23.1	−7.3	17.7
Non-ruble terms of trade (deterioration −)	1.1	2.4	−1.4	−8.5	−0.7	2.3
Ruble export volume	0.4	−6.0	−26.1	−56.4	−2.4	–
Ruble import volume	2.9	−6.9	−17.8	−55.6	−12.6	–
Exchange rate						
Nominal effective exchange rate (depreciation −)	−1.6	3.0	−3.8	−9.3	−5.4	4.9
Real effective exchange rate (depreciation −)	4.6	0.9	1.8	12.5	6.5	−4.0
		(As a percentage of GDP, unless otherwise specified)[9]				
External current account balance	−2.8	−4.9	0.4	0.8	0.9	−9.2
Gross external debt[5]	71.5	74.0	62.6	69.2	62.4	70.6
Net external debt[5]	50.9	54.1	46.9	44.5	38.7	43.5
Debt service ration (as a percent of export earnings)[6;7]	44.4	37.3	42.5	31.7	31.5	40.6

[1] All external sector data in convertible currencies, unless otherwise specified.
[2] Since 1991, most trade has been conducted in convertible currencies. Except for a reclassification of the GDR to the non-ruble area, figures from 1991 reflect the traditional split of ruble and non-ruble trade.
[3] Settlement basis.
[4] Customs basis.
[5] End-year stock, including use of Fund resources.
[6] Debt service, consisting of interest payments plus amortization of medium- and long-term obligations, including Fund repurchases, in percent of foreign exchange earnings (from merchandise exports, services and travel).
[7] Starting in 1991, the denominator includes all convertible currency exports or imports, including those to former CMEA markets previously settled in rubles.

Table 2

Hungary: selected external economic indicators, 1988–93[1]
(continued)

	1988	1989	1990	1991	1992	*Estimate* 1993
		(In billion U.S. dollars, unless otherwise specified)				
External current account balance	−0.8	−1.4	0.1	0.3	0.3	−3.4
Foreign direct investment	–	0.1	0.3	1.4	1.5	2.3
Enterprise borrowing abroad	–	–	–	–	–	1.0
Overall balance of payments	–	−0.1	−0.6	2.7	0.8	2.6
Gross official reserves (months of merchandise imports)[7;8]	4.7	3.5	2.3	5.3	5.2	6.8

[8]End-year stock. Official valuation of gold (US$ 320 per ounce).
[9]National accounts data since 1991 have been revised and are not comparable with those of preceding years.
Sources: Central Statistical Office, Ministry of Finance, National Bank of Hungary, and Fund staff estimates.

to meet the growth in domestic demand, stemming in large part from the budget deficit. As a result, the external current account position swung from a modest surplus to a large deficit in 1993.

Compared with other economies in transition, Hungary has attracted the largest direct investment inflow, and more recently, considerable enterprise borrowing from abroad. Besides helping to finance the current account deficit, this capital inflow facilitated restructuring, privatization, and not least, a substantial accumulation of foreign exchange reserves—to cover approximately seven months of imports. Nevertheless, the present external current account imbalance cannot be sustained indefinitely. Notably, close to one half of foreign exchange earnings have to be used to finance debt service payments (*Table 2*).

Output contracted sharply in Hungary over the past four years, primarily as an inevitable consequence of the transition from central planning. The contraction is directly attributable to the collapse of the CMEA and domestic markets, as well as to trade liberalization, and the concomitant restructuring or bankruptcy of enterprises, rather than to restrictive macroeconomic policies. The overall level and change of production reflects a complex process in the current phase of transition, which can perhaps best be described as a large-scale, almost Schumpeter-type, restructuring: the combination of declining or disappearing obsolete enterprises on the one hand, and emerging highly productive enterprises, on the other. It is par-

ticularly difficult to measure the performance of the latter group of enterprises, as many of them are operating in the so-called hidden economy. Estimates suggest that the hidden economy may well account for about one fifth of the officially recorded output in Hungary. In any event, after the Polish case, the Hungarian contraction has been the most moderate in the region, even according to the underestimated official figures. During 1989–93, GDP fell by about 20 percent in Hungary, compared with a net 13 percent decline in Poland.[4]

On the way to sustained growth

Against the above backdrop, after several years of declining output—despite distortions in the official statistics—there is naturally some impatience. Halfway through the transition, we can rightfully raise the question: when will the time come for economic growth? Instead of attempting to provide a direct, straightforward answer, it is more appropriate to *analyze the conditions for growth: a satisfactory growth rate that can be sustained in the medium term, that is, while maintaining macroeconomic equilibrium.*[5]

To start with, it should be recognized that Hungary has made considerable progress in fulfilling certain fundamental conditions for growth: through opening the economy, price liberalization, and creation of a number of market-oriented institutions. In addition, these conditions have been met in a stable political, social and economic environment, as compared with the neighbouring economies in transition. Notwithstanding these achievements, *Hungary is unfortunately still burdened with serious institutional impediments to entrepreneurship, performance, and ultimately growth. Such impediments are most prevalent in the capital and labour markets.*

In principle, in the *capital market*, the demand for capital is determined, *inter alia*, by the rental or user cost of capital. The cost of capital consists of the marginal rate of return required to yield the expected discount rate or interest rate—depending on whether investment is financed with equity or debt—adjusted for a risk premium, depreciation and company taxes. The latter include the statutory profit tax rate as well as the tax treatment of depreciation, interest expenses and capital gains.

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[4] Upon including the hidden economy, the drop in Hungary's GDP did not exceed 15 percent during this period. See *Árvay and Vértes* (1994).

[5] There is a growing literature that deals with the conditions for growth during the transition. In Hungary the best known work is *Kornai* (1993), which examines the prospects for growth primarily from the demand side. By comparison, the present study is concerned rather with the outlook for expanding production while maintaining macroeconomic equilibrium.

Under present conditions, in Hungary, bank loans are the potentially most important source of finance for the average enterprise. However, the spread between bank lending and deposit rates is rather wide. The interest spread, which exceeded ten percentage points during 1993, as compared to the average two percentage points in many industrial market economies, adds considerably to the cost of capital. The spread is determined by the effective reserve requirement rate (the statutory rate adjusted for the interest rate on reserves), the portfolio of nonperforming debts, and the profitability or inefficiency of banks. Thus, the interest spread can largely be considered a cross subsidy, or—from another point of view—a tax borne mainly by new loans. Finally, the cost of capital is further raised by the fact that the producer price inflation, relevant to enterprises, is much lower than the consumer price inflation, experienced by households, to be exceeded by the nominal after-tax deposit rate.

The combination of the interest spread, the risk premium and the effective company income tax may be referred to as a *fiscal or quasi-fiscal wedge*. The wedge can be *defined as the difference between the net required rate of return (after depreciation) and the net deposit rate (after withholding tax). In Hungary, this wedge, imposed on financial intermediation between investment and saving*, totals about 10–20 percentage point (*Appendix*).

In the *labor market*, costs consist of wages, wage-related and non-wage costs, and payroll contributions for social security. Other regulatory expenses—hiring costs and, more importantly, firing costs (severance pay, etc.)—have increased recently and, although less explicitly, also add to labor costs in cash and in kind. Social security contributions and such regulatory costs, again represent a cross subsidy from the active work force to old-age pensioners, the unemployed and other recipients of social benefits. At the same time, *the effective rate of contributions and the less explicit hiring and firing costs form a quasi-fiscal wedge between employees and employers, imposing a serious burden on the labor market*. The portion of the wedge associated with the various payroll contributions constitutes an additional 55 percent expenditure over and above the pre-contribution wage and wage-related costs (*Appendix*). In contrast, the same wedge averages roughly 30 percent in industrial economies and is even lower in most developing countries.[6]

In general, *fiscal and quasi-fiscal wedges curtail the work effort, employment, capital formation, and financial savings (especially in bank deposits). In addition, they undermine the country's external competitiveness, and curb production and economic growth*. To the extent the wedges are borne by the formal labour force and domestic commercial bank lending, they lead to *major distortions in resource*

[6]The comparable wedge in OECD countries varies between 12 percent (United Kingdom) and almost 57 percent (France). The magnitude of the wedge would be much higher if we were to include the marginal personal income tax rate—reducing net wages thereby—left out of the calculation partly due to its dispersion and partly because it is probably shifted onto the employee.

allocation. Mainly in response to these wedges, an increasing number of channels have emerged, offering ways to avoid the wedges, notably through informal employment, in the labour market, and through foreign currency borrowing mainly from foreign banks, in the capital market. Foreign financial intermediation is also used to avoid the crowding-out effect of the massive issue of government securities at relatively attractive, risk-free interest. With the proliferation of such leakages, there is necessarily an increase in the wedges for those who cannot escape them for various reasons.

In a simplified analytical context, the demand for capital of profit-maximizing firms is in part a function of the cost of capital, while their labour demand is determined in part by the cost of labour. Thus, through these costs, the wedges exercise a negative effect on output growth. Within such a theoretical framework, rough quantitative estimates suggest that, *ceteris paribus*, if the interest spread was reduced by one percentage point, GDP would increase by about one percent. Similarly, one percentage point reduction in the social security contribution rate would result in almost half a percent increase of GDP in the long run (*Appendix*).

These illustrative estimates are, of course, subject to a number of limitations. The effects are underestimated as they disregard important economies of scale and dynamic effects, the latter also being captured in total factor productivity. In the Hungarian economy, these effects, including interaction effects, would also add to the above estimates. In addition, the increase in output supply would induce a general drop in the real interest rate; the resulting increase in domestic demand would also lead to positive production effects.[7] At the same time, the effects may be overestimated as they also include those parts of the labour and capital markets which effectively avoid the wedges. Nevertheless, on balance, the results are conservative because underestimation most probably outweighs any overestimation.

In Hungary, we often see successful firms which are far from exploiting economies of scale and voluntarily reject any idea of expansion. One of the most frequently cited reasons lies in the disincentive created by the high statutory contribution rates and various labour regulations, which small businesses find relatively easy to avoid. Beyond a certain size, the entrepreneur feels obliged to come out of the hidden economy. Likewise, high interest rates, among other things, which determine the cost of capital, compel small entrepreneurs to finance investments from their limited savings. Meanwhile, the large government borrowing requirement absorbs an increasing share of household and enterprise savings. This results in a major crowding-out effect, through combination of high interest yield and low risk on government securities.[8] In summary, *through the wedges, the state directly or*

[7] *Bayoumi et al.* (1989) contains an analysis of these macroeconomic demand effects. Of course, such effects also depend on any fiscal action taken to compensate for the reduction in the wedge.

[8] One sign of the crowding-out effect was that in the course of 1993 the yield on government paper approached or reached the interest rates on enterprise debt.

indirectly weighs heavy on the most critical economic linkages. Thus, the wedges inhibit potentially successful activities during the very adolescence of the market economy.

Clearly, in Hungary, there is considerable scope for encouraging growth from the supply side. Therefore, *besides developing the necessary infrastructure, for Hungary to attain a sustained and adequate rate of economic growth*, it is necessary to remove or reduce the present fiscal or quasi-fiscal wedges, supported with a macroeconomic stabilization effort. Such a growth path would not fuel inflation or contribute to external disequilibrium—on the contrary, it would help ease the debt burden. Infrastructure investment has an important role in enhancing the efficiency of private investment. Nevertheless, infrastructure financed by the government should not take place at the expense of a further widening budget deficit.

In contrast, an expansionary fiscal policy would lead to continued crowding out of private investment and accumulation of public debt. By absorbing scarce private domestic savings, the fiscal imbalance would, at the same time, aggravate the current account deficit. This would, in turn, call for frequent and sizeable exchange rate adjustments, intensifying inflationary pressures. Thus, after some short-lived growth, these pressures would inhibit investment and production would further stagnate.

There are examples worldwide of structural adjustment coupled with a prudent budgetary and monetary stance—possibly even characterized as restrictive—that have led to high sustained growth. It is, in fact, such a consistent economic policy mix, rather than cultural or ethnic factors, that explains the extraordinary growth in south-east Asia.[9] In addition to maintaining macroeconomic equilibrium, most countries in that region eliminated or substantially alleviated financial repression, and have only recently started to build rather modest social security systems, financed with insignificant contribution rates.[10] Similar lessons can be drawn from the examples of other developing countries that reached high rates of growth only after launching serious adjustment programs: for instance, Turkey in the early 1980s, Mexico in the late 1980s, and Argentina in the early 1990s.[11] They all made efforts to remove or reduce similar wedges—of a much smaller size than in Hungary—in combination with strict macroeconomic stabilization, typically in response to a severe external payments crisis, high inflation and stagnation.

[9] This was a major conclusion of the research recently completed at the *World Bank* (1993); see also *Petri* (1993).

[10] For example, Indonesia, Korea and Thailand have just established traditional social security pension systems, while only provident funds are operating in Singapore. It is interesting that the Philippines, almost as an exception in this region, with a social security system financed with sizeable payroll contributions and experiencing macroeconomic disequilibria, has shown the weakest economic performance.

[11] *Kopits* (1987) and *Loser and Kalter* (1992) analyze the cases of Turkey and Mexico, respectively.

Major tasks ahead

The above overview sets out the tasks which have been left for the next phase of the Hungarian transition. They are tasks that, if accomplished, would encourage the reduction of the existing wedges or at least prevent them from widening, thereby ensuring faster sustained growth. To this end, the most urgent tasks include the successful completion of bank consolidation and related enterprise restructuring; reform of government finances; and reform of the social security systems. Parallel to such reforms, prudent macroeconomic policies are essential. The following subsections provide a broad outline of these tasks.

Bank consolidation and enterprise restructuring

Much effort has already been devoted to restoring the viability of state-owned commercial banks and to ensuring their adequacy for a market economy. It is worth noting that, albeit on a smaller relative scale, comparable rescue operations involving financial institutions have taken place in several market economies. Actual procedures and practices differed across countries. Whatever the ideal solution might be, the success ultimately depends on implementation. As banks have been recapitalized with government bonds, part of the interest spread which reflects non-performing assets has been explicitly absorbed by the budget as interest expense. In other words, at least in principle, the bad debt burden is shifted from new borrowers onto the taxpaying public at large.[12] This, however, can be regarded only as an initial step.

As a matter of fact, the bulk of the exercise has hardly begun. On the one hand, *loss-making indebted state-owned enterprises have to be restructured or liquidated*, preferably applying the provisions of the existing bankruptcy law as widely and effectively as possible. On the other hand, on the basis of restructuring contracts, recapitalized banks will have to be encouraged to rationalize their operations with sufficient rigour, subject to efficient supervision and sanctions. It is advisable to take every opportunity for privatizing commercial banks, at most, if necessary, with the government remaining only as a silent partner.

Ultimately, any bank rescue operation should be guided by the principle that nobody, without exception, should expect such an exercise to be repeated in the future. This is the only way to eradicate moral hazard and to ensure that no more bad loans are generated, except perhaps for those that inevitably occur in the normal course of business. Therefore, it is essential to speed up the necessary changes

[12] The effect of non-performing bank portfolios on the interest spread can be estimated on the basis of the methodology developed in *Dittus* (1994). Such estimates suggest that the interest spread would have been about 2.5 percentage points lower in the absence of non-performing loans.

in the behaviour of commercial banks. As a corollary, efficiency will increase in the enterprise sector to the extent the budget constraint is hardened through the terms and availability of bank loans, and not only through the already completed reduction in government subsidies.

Reform of government finances

Although some important steps have been taken, notably the elimination of price and other enterprise subsidies and the explicit recognition of interest expenses, the bulk of the fiscal reform has yet to be implemented (*Kopits* 1993). The most important areas that require attention include the tax system, the budget structure and process, and the relationship between central and local governments. The reform should serve the following major objectives: cost-effectiveness, transparency, accountability and fiscal balance—to be understood on average over the business cycle. In broader terms, the reform should aim at delineating clearly the role of the state in the market economy.

In the field of taxation, *renewed efforts are needed to broaden the tax base to the extent possible, so as to enable lowering the present high marginal rates*. The rates of indirect taxes (especially the VAT) should be brought down to the harmonized level that exists in the European Economic Area. Similarly, the enterprise profit tax rate could be reduced further. But in all cases, the tax base should first be broadened—through both legislative action and improved tax compliance—in order to ensure a level playing field and sufficient revenue yield. Meanwhile, the rates could gradually be reduced according to a preannounced timetable, giving a useful signal to households and firms. *The revenue forgone because of tax preferences should clearly be presented in the annual budget law* just as any expenditure item; such a tax expenditure budget is prepared regularly in a number of western market economies. In the course of the budget debate, the parliament could thus decide on tax expenditures at least in principle.

The present structure of the budget is characterized by excessive decentralization. The central budget contains too many independent budgetary institutions which finance their expenditure partly from their own revenues, subject to loose control. These institutions do not always provide public services, but may be engaged in profit-making activities. In addition, a number of extra-budgetary funds have been created with very loose ties to their respective supervisory ministries. *Central budgetary institutions that do not provide public services should be removed from the budget, while the others, including most extra-budgetary funds, should be integrated in the central budget*. In this manner, all spending programmes would be equally subject to government and parliamentary scrutiny and decision-making.

The division of responsibilities between the government and the central bank in the management of domestic and external debt deserves special attention. As a remnant of the previous regime, the conduct of these responsibilities is neither transparent nor efficient. Meanwhile, inefficient cash management, especially as regards central budgetary institutions and extra-budgetary funds, makes the use of fiscal resources unwieldy and contributes to the budget deficit. The lack of transparency may even give rise to corruption. In order to correct such shortcomings, *an up-to-date information system and a single national treasury are necessary to help centralize and to enhance the cost-effectiveness of the management of public debt and cash resources*. The operating costs of these new institutions, including foreign debt service, would appear fully in the budget. This innovation would in part relieve the central bank from the responsibility of debt management. The bank could be concerned primarily—if possible, exclusively—with the conduct of monetary policy, including the exchange rate. These reform measures would contribute to a flexible, transparent, cost-effective and market-oriented fiscal policy.

The phaseout of consumer and producer subsidies, which marked the first phase of the transition, was accompanied by a number of innovative steps in the budgeting process (e.g. introduction of accounting and auditing rules, establishment of the General Accounting Office). Nevertheless, the programmes and priorities inherited from the previous system still dominate the budget process and the structure of expenditures in several respects. Given their many other responsibilities, the government and the parliament focus primarily—in some areas, exclusively—on annual changes in expenditures. Therefore, there is an urgent need to launch a thorough and systematic review of all budget programs, including decentralized institutions, and extra-budgetary operations, assessing all human and material resource requirements. *Indeed, in an economy in transition, it would be particularly appropriate to encourage the application of a zero-base budget.*[13] Full application of this method is, of course, time-consuming. As it would take a certain period (say, three years) to implement even superficially, it should be started without delay. The details of the method should be tailored to local circumstances. However, more important than the method itself, zero-base budgeting should become ingrained as a broad approach or as a "mindset", regarding all budget decisions, at all levels of public administration—the central government, the parliament and local governments. This approach would help to define the role of public finances in the economy.

[13] The essence of the zero-base budget method is that it prescribes justifying the operation of every single government program, its structure and its resource use. For this purpose, it is necessary to identify the objective of the program and the fulfilment thereof. The method forces budget decisions in accordance with the priorities set by the government. International experience—for example, in the United States and Australia, primarily at the local state level—shows that comprehensive adoption of the method requires considerable information and expertise.

A comprehensive review of government expenditures would, of course, entail a major reallocation of resources in public finances. Similarly, certain functions would need to be removed, with obvious implications for staffing. Although perhaps not immediately, the approach would lead to substantial budgetary savings, especially in current primary expenditures. Such savings would give room for certain automatic expenditures, for much-needed infrastructure investment and for new priority outlays, and thus would contain the magnitude of the budget deficit. Hence, the budget reform and the reduction in the deficit would essentially reduce the wedge on financial intermediation—including the relatively high reserve requirement rate—and mitigate the crowding-out effect, thus contributing to economic growth. It should be noted in this regard that among automatic expenditures, interest payments on the public debt are rising fast and their size is comparable to the level of the budget deficit. Therefore, there should be an increasing *effort to generate a substantial primary budget surplus, or at least adequate to ensure that the ratio of public debt to GDP be stabilized.*[14]

Along with the rationalization of various public institutions, the integration of several extra-budgetary funds and the introduction of the zero-base approach, *it would be particularly important to modernize the government procurement function.* At present, as in the past, most government procurement takes place through internal channels, in a highly fragmented manner. However, the emergence of the market economy makes it increasingly possible for the government to purchase goods and services (e.g., auto servicing, laundry) in the open market.

As a broader issue, *it would be appropriate to introduce a sufficiently quantified medium-term budget plan*—considering the gestation period of certain major infrastructure projects—with specific objectives regarding stabilization and growth. It would be useful to prepare, and to update from year to year, alternative scenarios to support the medium-term budget plan. Such a rolling budget approach, subject to formal approval by the parliament, would enable formulation of a medium-term fiscal consolidation strategy within a consistent macroeconomic framework. For this purpose, certain lessons could perhaps be drawn from the 1991–93 medium-term program.

Local government finances are somewhat undefined and relations with the central government are complex, while regional economic differences seem to be

[14] More precisely, the change in the ratio of government debt relative to GDP in time t is:

$$\Delta a_t = k_t - y_t + (i_t - g_t - p_t)a_{t-1},$$

where a is the ratio of government debt to GDP, k the ratio of primary (non-interest) government expenditure to GDP, y the ratio of government revenues to GDP, i the effective average interest rate on government debt, g real GDP growth, and p is the change in the GDP deflator. If the debt to GDP ratio is not to increase, then the primary budget surplus must be at least as large as the amount by which the interest rate on the government debt exceeds the economic growth rate.

widening, notwithstanding Hungary's small size and homogeneity. In order to eliminate regional disparities, more efficient and *transparent local government finances would be needed, under a system that takes into account the revenue capacity and expenditure needs of each region*. This could be achieved most effectively with a regional transfer mechanism, based on a comprehensive regional indicator, to replace the existing complicated and arbitrary system of normative transfers. The indicator would be determined by a weighted aggregate—specified jointly by the main participants (local governments, central government, parliament)—of, say, income per capita, population size under each local jurisdiction, etc. In addition, of course, infrastructure or other projects of national importance would continue to be financed from targeted central budget resources. As an integral part of a new approach, revenue collection should be encouraged at the local level. In particular, *local governments should raise their own resources, primarily by introducing a property tax*[15] *and extending local user fees*. The present revenue sharing arrangement involving the personal income tax could be replaced with a local personal income surtax—at rates specified under each local jurisdiction—which would be added to the centrally levied personal income tax, imposed at a reduced rate.

Social security reform

In the eyes of a Western observer, the debate which revolves around the social security system in Hungary is difficult to understand. While governments, parliaments, trade unions and other interest groups in western Europe are considering ways to trim payroll contribution rates thus of lowering benefits because of their adverse effects on competitiveness and employment, the emphasis in Hungary is placed on the need to raise of benefits. This contrast is even more striking since the statutory contribution rates in Hungary rank among the highest worldwide.

The present Hungarian social security system is not sustainable financially, even under the relatively optimistic demographic and macroeconomic scenarios in the medium to long run. Absent any corrective action, the social security funds will again require additional budgetary support or increases in contribution rates, which would, of course, eventually further worsen the financial imbalance in the funds. Instead, it is necessary to move in the opposite direction; *namely, cut the contribution rates. For this purpose, as a first step, the contribution base should be extended to cover all wages and wage-like compensation including benefits in kind*. At the same time, administrative measures—in part linked to the administration

[15] It would be relatively simple to levy the property tax on the value of real estate and vehicles (automobiles, planes, boats), which the local self-governments would be able to do most efficiently. In contrast, the introduction of a wealth tax would require the measurement of net wealth, in the face of significant practical and legal obstacles in Hungary today.

of personal income tax—are needed to extend the contribution obligation to the hidden economy, which would permit a further cut in the contribution rate.[16]

Apart from the aforesaid measures, it is inevitable to *narrow the scope of benefits and entitlements*, unpopular as it may sound. Of course, this does not mean that the *existing* old-age pensions should be modified; in fact, they should retain their value in the face of inflation, especially above a certain age and a certain inflation rate. However, the automatic inflation-adjustment provision should be only implemented as part of a comprehensive reform package. Within that package it would be useful first to conduct a re-certification of all the benefits currently granted which may dysfunctionally substitute for unemployment benefits or which are prone to large-scale abuse—even though apparently they do not impose a direct burden on employers or employees. Such benefits include early retirement pensions, partial disability pensions and sick pay.[17] Significant progress could be made by cleansing these benefits of dysfunctional cases or of those based on abuse. Similar to other market economies, sick pay could be replaced with sick leave. In the context of each employment contract, sick leave would be financed and directly supervised by the employer. *In the health-care area, just as it was done in the case of food subsidies, it would be appropriate to abolish the price subsidy on medicines and to provide such subsidy as any other form of social assistance, only to those in need.* On a similar basis, the direct payment for health-care costs by patients should be expanded, both in terms of magnitude and types of service.

The criterion of need should be applied more widely, for example, in the case of benefits such as maternity and child-care allowances. Accordingly, *all benefits should in general be incorporated in the personal income tax base*, to the extent the underlying contributions have been excluded from the tax base. In addition to these steps, aimed at improving cost-effectiveness relatively quickly, a number of reform measures, especially under the old-age pension scheme, can be adopted only gradually—according to a pre-announced schedule—and their impact will be felt over time. One such measure involves the increase in *the retirement age along with the introduction of a flexible formula whereby, around a central retirement age*, additional years in service would be encouraged and fewer years discouraged through a marginal increment and decrement, respectively, in the replacement rate. Another measure along the same lines would be the adoption of a linear *marginal*

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[16] In this connection, occasionally it has been recommended that social security contributions should be pared down and that additional VAT revenue should be raised to finance social security benefits. This proposal is not viable for at least two reasons. One is that all tax revenue is needed to cover budget expenditures and the VAT rates are already too high by international standards. The other is that such a step would undercut even more the important link between payment of contributions and entitlement to benefits, which, under the insurance principle, should be strengthened in order to encourage the willingness to pay the contribution.

[17] It is noteworthy that the number of disability pensions increased by about 50 percent between 1989 and 1993.

benefit accrual rate over the service period for the computation of the pension base, and to extend the computation of the base to include all years in service. More generally, as the aforesaid measures reduce the replacement rate of pensions or limit the health-care benefits to those in need, private insurance schemes and private pension funds will have an increasingly important complementary role to play in the emerging market economy.

As an indispensable element of a carefully designed reform program, long-term quantified scenarios need to be developed—as done in some countries—on the basis of alternative demographic and macroeconomic assumptions. Such scenarios are useful to determine the magnitude of necessary adjustment, for example, in old-age and disability pensions or health-care services, and to determine the ensuing speed and extent of the possible future cuts in contribution rates. Moreover, it would be informative to present long-term scenarios, together with the annual state budget, to parliament, and on a routine basis, as this would be an essential input for reaching the required social consensus on the design and implementation of reform in this area.

Toward macroeconomic equilibrium

An important ingredient of a successful transition is the maintenance of external and domestic equilibria during implementation of the structural reform. Containment of inflationary pressures is particularly necessary to strengthen financial intermediation and to boost fixed capital formation which will lead to sustained growth. The examples mentioned in South-East Asia, and more recently in Latin America, underscore the essential role of macroeconomic equilibrium in sustained growth. By contrast, an overheated economy may also grow but such growth is generally short-lived insofar as it ends up in an inflationary spiral or balance-of-payments difficulties—as experienced by a number of countries in the past.

In the case of Hungary, to the extent that the reform process may even undermine equilibrium in the short run—mainly with regard to the budget—it may be necessary to keep certain contingency measures in store. Overall, *such measures should be incorporated within a set of consistent and coordinated fiscal, monetary and incomes policies.*

Concluding remarks

In conclusion, on the basis of past achievements and accumulated experience, Hungary faces a series of important tasks in the next phase of the transition to a market economy. The common denominator in these tasks is the need to remove,

or at least to ease, the fiscal and quasi-fiscal wedges that curb economic growth. The tasks can also be interpreted as the rationalization of the role of government in economic life, much of which has remained intact since the previous regime. The implication is not that the state should withdraw from all activities, especially those from where market failure justifies intervention. Instead, the goal is to change the role of the state, first of all to enhance cost-effectiveness: namely, maximum economic and social welfare is to be achieved at minimum fiscal and allocative costs, in the medium to long term. Such allocative costs include the erosion of work effort, and of the propensity to save, and disincentives to capital and labor demand.

In recent months, the view has often been heard that implementation of the reform of government finances, as well as the social security system, must await the take-off to growth. The arguments presented in this paper suggest precisely the opposite: bank consolidation, enterprise restructuring, the fiscal and social security reforms are all very much needed as a precondition to sustained growth. Admittedly, however, such major reform steps will depend on the government's ability to create consensus among key interest groups. The latter can, however, be achieved only if reform measures are presented as a package within the framework of a comprehensive economic strategy.

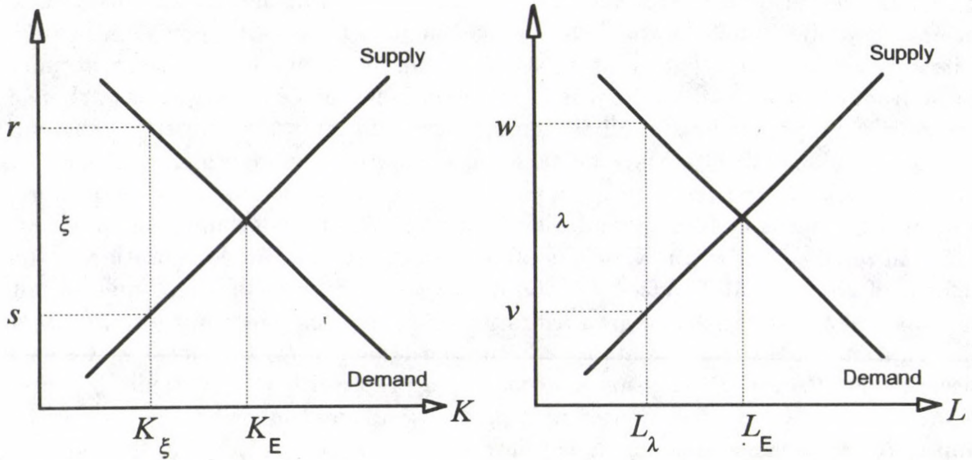
Appendix

Fiscal and quasi-fiscal wedges in the capital and labour markets

In a simple economy consisting of a household sector and an enterprise sector, households offer labor services to enterprises in exchange for wages. The wages are partly spent on consumption and partly saved and lent to enterprises for capital formation. Both labor and capital are used by enterprises for production.

More realistically, the contacts between the two sectors are affected by the government or the social security system in the labour market and by the banking system in the capital market. Both systems impose fiscal or quasi-fiscal wedges between supply and demand in each factor market. A major difference between the two is that while the basic function of the banking system in the capital market is to bring supply and demand together, through financial intermediation, the social security system serves to separate supply and demand in the labor market. In theory, the wedge in the capital market could be virtually eliminated, while the wedge in the labor market could be only reduced. However, in practice labor market regulation, banking regulation, and taxation contribute to an increase in wedges. The graph illustrates this situation. (See *Figure 1*)

The adverse effects of the wedges on capital formation ($K_E - K_\xi$) and employment ($L_E - L_\lambda$) are depicted in a partial equilibrium framework. The size of



where r is the net required rate of return of investment, s is the expected after-tax interest rate on bank deposits, K_E is the equilibrium supply of capital, K_ξ is the actual supply of capital, v is the net wage, w is the gross wage cost, L_E is the equilibrium supply of labour, L_λ is the actual supply of labour, λ and ξ are wedges in the labour and capital markets, respectively.

Fig. 1

the effects depends on the corresponding interest rate and wage elasticities. There are numerous leakages on both factor markets which blunt these effects. That is, through work performed in the hidden economy, to avoid social security contributions, or through foreign borrowing by enterprises, to bypass the Hungarian banking system.

Effect of fiscal wedges on economic growth

A simple partial-equilibrium neoclassical model can be used to track the effect of capital costs and labor costs on output growth. The steps involved are as follows. First, it is necessary to define the user cost of capital and the cost of labor, and to identify the fiscal or quasi-fiscal wedges contained therein.[18] In the second step—given the production function and the resulting marginal productivity of

[18] Calculations pertaining to a number of countries can be found in Kopits (1982) and *Andersson* (1991).

each factor—we calculate the demand for factor inputs; then, by substituting these into the production function, we solve for the level of output. In the third step, we examine the partial effect of a marginal increase in the wedges, through each factor, on output.[19]

The user cost of capital is defined as:

$$c = \frac{1 - uz}{1 - u}[i(1 - u) + \delta - \dot{q}]q,$$

where c is the user cost of capital, u the statutory marginal profit tax rate, i the nominal cost of borrowing, δ the rate of economic depreciation, $\dot{q}$ the expected rate of capital gains, z the present value of tax depreciation, and q denotes the price level of capital assets.

It follows that the real required rate of return, net of depreciation, is

$$r = \frac{1 - uz}{1 - u}[i(1 - u) + \delta - \dot{q}] - \delta.$$

After subtracting the withholding tax, the expected real interest rate can be approximated by

$$s = b(1 - f) - \pi,$$

where b is the nominal interest rate on bank deposits, f the withholding tax, and π is the expected rate of inflation.

Thus, in the capital market, the wedge between the minimum rate of return on investment and the expected interest yield on saving is given by

$$\xi = r - s.$$

The calculation of the wedge can be modified to accommodate alternative assumptions about the firm. In the first place, is the enterprise paying taxes, does it have a taxable profit? If it is not paying taxes, then it is impossible to subtract depreciation and interest costs from the tax base, thereby raising the cost of capital and the wedge. By the same token, the taxation of capital gains has an opposite effect. Second, is the enterprise using equity financing? The cost of equity cannot be subtracted from the tax base, thus raising the average cost of capital. The use of an average deposit rate and an average borrowing rate under current conditions in Hungary may represent a major oversimplification because financial markets are still rather segmented and added bank charges (including those involving compensatory balances) appear over a wide range of interest rates on bank loans.

[19] A similar method can be used to analyze the effect on growth of foreign debt and the cost thereof. See *Hernandez-Catá* (1989).

The cost of labor services can be divided simply into two parts: one is the wage payment before income taxation, but excluding social security contributions; the other consists of social security contributions of both employers and employees. Thus, the total labor cost can be defined as:

$$w = v + \lambda,$$

where w is the gross wage cost, v is the wage before taxation and excluding compulsory social security contributions, and λ is the effective social security contribution.

Excluding the implicit cost of labor market regulations, λ can be regarded as the fiscal wedge between gross and net wage payments.

$$\lambda = w - v$$

and the effective rate of the wedge in the labour market is

$$j = \lambda / v.$$

Despite some statistical difficulties, it is easier to calculate the components of labour cost than those of capital cost.

For convenience, let us specify a Cobb-Douglas production function:[20]

$$Q = AK^{\alpha}L^{\beta},$$

where A is total factor productivity, K fixed capital stock, L the effective labor force, Q output, α the capital elasticity of output, and β the labor elasticity of output.

Solving for the familiar marginal conditions (that is, maximization of the firm's objective function) yields the demand for the corresponding factor inputs:

$$K = \alpha pQ/c \qquad \text{and} \qquad L = \beta pQ/w,$$

where p is the price level of output.

Next, the demand for each factor is substituted into the original production function—abstracting from simultaneity problems—under the assumption that factor demand is determined by past (rather than present) output. This approach is plausible as the focus of the analysis is the rate of change—rather than the absolute level—of output in response to a marginal change in a given component of factor cost.

[20] For a survey of the relevant literature see, for example, *Chenery, Robinson and Syrquin* (1986).

Application to the case of Hungary

The following is a list of variables and parameters quantified on the basis of current Hungarian data.

u=36 percent statutory enterprise profit tax rate.

i=30 percent nominal interest rate; although bank lending rates for enterprises are about 25 percent (Hungarian National Bank), they can reach 30 percent including various administrative and other bank charges. In addition, many small and medium-scale enterprises must pay interest rates substantially higher than this rate. In all, the effect of nonperforming loans, high risk premia and various tax elements contribute to high interest margins.

δ=10 percent average rate of depreciation, weighted average of a range of recent investment by broad asset type (Central Statistical Office).

q=12 percent expected growth in asset value, assumed to be equivalent to the change in the industrial producer price index.

z=40 percent, the present value of tax depreciation given by a weighted average of annual statutory depreciation rate for machines (14.5 percent), buildings (3 percent) and vehicles (20 percent), calculated as $\sum_t^n a_t/(1+i)^t$, where a_t is the tax saving due to depreciation in the year t, and i is the interest rate.[21]

j=55 percent effective payroll tax rate for social security, taken from a 1992 survey (Central Statistical Office), covering the pension, health-care and unemployment insurance contributions paid by employers and employees, as well as compensation of employees whether subject or not to compulsory contributions. (This means that a HUF 55 obligatory contribution is payable on top of HUF 100 in wage and wage-type payments, net of contributions but gross of personal income taxes.)[22]

[21] For the sake of some precision we should note that when studying the interest rate sensitivity of output, one must also take into consideration the effect on z of changes in i, estimated roughly at 0.7.

[22] This must be distinguished from the statutory contribution rate, which is determined as a proportion of wage payments net of the employer share, gross of employee share. In 1992–93, this rate was 51 percent for the employer and 12 percent for the employee. According to the 1992 survey net wages subject to contribution were 57 percent, employer contributions were 29 percent and noncontributory wage costs were 14 percent, for a total of 100 percent. Taking into consideration the employee share of 10 percent pension and health-care contributions, and the 2 percent to be paid to the solidarity fund, the wage before the personal income tax is actually 88 percent of the 57 percent, which is 50 percent; there is also 14 percent which is income, not subject to contribution, making a total of 64 percent. In addition to the 29 percent contribution, social security also gets 12 percent of the 57 percent. The latter represents a 36 percent wedge relative to the gross labour cost (w), or a 55 percent wedge in the ratio of labor costs without contributions (v). We should note that the wedge, as defined here, involves only the social security system, so it

α=30 percent and β=70 percent are the capital and labour elasticity of output, respectively, assumed on the basis of international experience (*Chenery, Robinson and Syrquin* 1986). The condition $\alpha + \beta = 1$ reflects constant returns to scale, even though for the Hungarian economy probably it might be more realistic to assume increasing returns: namely, $\alpha + \beta > 1$.

$b(1-f)$=15 percent is the average bank deposit rate, subtracting f=10 percent, the withholding tax rate.

π=22 percent, assuming that inflation expectations are formed on the basis of the 1993 average consumer price inflation, even though the underlying inflation rate had declined to around 18 percent by mid-1994.

In the capital market the wedge (ξ) was approximately 20 percentage points, upon substituting the above data, and given a 13 percent (r) required rate of return. Of course, this result is sensitive to a number of key assumptions, in particular regarding inflation expectations, effective interest rates on bank deposits, and credits. If, for example, we reduce the lending rate from 30 percent to 25 percent, raise the net deposit rate from 15 to 16 percent, and set the expected inflation rate at only 18 percent instead of 22 percent, then the wedge falls to 10 percentage points. Therefore, the wedge can be said to range between 10 and 20 percent. In the labour market, wedge (j) is estimated at 55 percent of wage costs, excluding contributions.

Given the above data, one percentage point reduction in the nominal interest rate (i) leads to approximately one percent increase in output, according to the following:

$$\frac{\frac{\Delta Q}{Q}}{\Delta i} = \frac{\frac{\partial Q}{\partial i}}{Q} = \frac{-a}{i + \frac{\delta - q}{1-u}} \cdot \left\{ 1 - \frac{u[i(1-u) + \delta - q]\frac{\partial z}{\partial i}}{(1-u)(1-uz)} \right\} < 0.$$

Similarly, a one percentage point reduction in the effective compulsory contribution rate results in a 0.4 percent increase in output according to the following relationship:

$$\frac{\frac{\Delta Q}{Q}}{\Delta j} = \frac{\frac{\partial Q}{\partial j}}{Q} = -\frac{\beta}{1+j} < 0.$$

Effect of a hypothetical investment tax credit

With a minimal extension of the above model, we can examine the effect on the cost of capital and thus on output, of an investment tax credit—or cash

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does not contain what might be realized through the personal income tax. The tax system cannot be ignored either, because social security gets some support from the central budget as well.

growth—made available to enterprises in proportion to the value of the investment. By inserting an investment tax credit or subsidy (k) into the definition of the user cost of capital, we obtain:

$$c = \frac{1 - k - uz}{1 - u}[i(1 - u) + \delta - \dot{q}]q.$$

The calculations suggest that the production effect of the introduction of an investment tax credit of about 3–3.5 percent would be equivalent to a one percent interest rate reduction. Although these two measures would not be strictly equivalent from a policy perspective, especially from a budgetary viewpoint, the enterprises would feel a certain substitutability between the two measures.

Limitations of the analysis

Partial equilibrium analysis imposes an important theoretical limitation, in that it disregards the various feedbacks operating in the economy—primarily through the budget. For example, a cut in the social security contribution rate decreases budget revenue and *ceteris paribus* increases the deficit and the financing requirement, which in turn, raises the interest rate and thus, it dampens the supply side effect of a reduction in the contribution rate. Hence, it is necessary—as explained in the text—to support an easing of the wedges with significant structural reform steps. In addition, the simplification introduced in order to avoid simultaneity problems according to which the demand for factor inputs is determined by price and output levels given in the previous time period, may be questioned insofar as our analysis refers to the change between two equilibrium states and encompasses continuously several decision-making periods. In reality, between two equilibrium states, there are also cumulative strengthening and restraining effects that cannot be handled by the model. Moreover, it is difficult to deal with uncertainty and risk that prevail in a transition economy.

From a practical point of view, the limitations include the already mentioned leakages, as well as the differences in the economic and financial situation of enterprises. In fact, however, it was only possible to estimate rough averages here. Perhaps more important is the unstable nature of the various parameters and functions associated with the transition character of the economy. Finally, it is worth emphasizing that the estimates of the growth effect are meaningful primarily in the long term and are to be regarded as scenario calculations.

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UNEMPLOYMENT AND EMPLOYMENT POLICY IN CENTRAL AND EASTERN EUROPE: SIMILARITIES AND DIFFERENCES*

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The transition economies of Central and Eastern Europe (CEE) were suddenly overwhelmed by high unemployment; this promised to be persistent and thus the respective governments started to seek the right ways for getting it under control, and cushioning its impacts. The questions to be answered are identical in every country: How and why did open mass unemployment emerge? Who are the unemployed? Which factors determine the acute differences within a particular country in the size and risk of unemployment? What can be done to slow down the growth of unemployment and to counterbalance its economic and social consequences? I will attempt to elaborate fragmentary answers to these questions, departing from the facts and considering the uncertainties and the doubts of interpretation, of methodology, and of economic policy.

The emergence of unemployment

In some countries in the region the growth of unemployment began with the collapse of the old régime; it accelerated significantly in 1991, and continued—albeit at a slower pace—in 1992. In Poland, Hungary and Slovenia, where transformation is most advanced and partial reforms had already been carried out earlier, unemployment rose by the highest margins. There were unemployment rates around 13 percent by the end of 1992: 13.8 percent in Poland, 13.2 percent in Slovenia and 12.3 percent in Hungary. These rates, high even by European standards, kept growing in all three countries, reaching 15 percent in Poland and approaching the same level in Slovenia, and culminating just above 13 percent in Hungary (although Hungary's figure started to slip downwards from March 1993).

Czechoslovakia, which started its transition from a back row position, (i.e. without any reform antecedents) is a special case. It fits into the group of the above-mentioned three countries in that there, too, unemployment grew fast in

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1991 to reach 6.6 percent by the end of the year (4.1 percent in the Czech part and 11.8 percent in Slovakia). However, available data suggest that by the end of 1992, this was already 5.5 percent less than a year before (it began in January 1992 and reached its peak in November). This general indicator, however, conceals staggering differences. Had Slovakia been independent at the time, its 10.8 percent unemployment rate would have secured it a place in the top group. With its 2.6 percent unemployment rate, the Czech Republic was the zone in the region least hit by unemployment. In Slovakia after the separation, unemployment rose to over 13 percent, while in the Czech Republic it is still (at the time of writing) below 3 percent.

In Romania, economic transition started out with grave disadvantages and not only due to a lack of antecedents. Unemployment, officially recognised by the end of 1990, began to rise steadily in late 1991; in 1992 its fast acceleration pushed the figure up to 9.2 percent. Thus it approached the generally high unemployment rate of the region.

There are major differences among the countries in question with respect to the quantity and quality of available unemployment data. In countries like Romania and, up to a certain point, Czechoslovakia, unemployment can only be examined through data provided by registration (i.e. the "signing-on" of unemployed individuals).

Table 1

Registered unemployment as a percentage of the labour force (active population) unemployment rates at the end of the period

Year	Czecho-slovakia	Czech-lands	Slo-vakia	Hungary	Poland	Romania	Slovenia
1989	–	–	–	0.5	..	–	3.2
1990	1.0	..	..	1.0	3.0	..	5.9
1991	6.6	4.1	11.8	8.5	11.8	3.0	10.1
1992	5.5	2.6	10.8	12.3	13.8	9.2	13.2
				10.4^{S}	13.5^{S}		8.3^{S}
1993							
1st quarter		2.9	12.0	12.9	14.2	9.3	13.5
2nd quarter		2.8	13.5	12.7	15.2	9.4	14.5
		3.9^{S}	12.4^{S}	12.0^{S}	13.8^{S}		

Note: ^{S}Data according to Labour Force Survey

Source: Employment Observatory 1992, 1993; Country studies; Labour force surveys

In Poland, Slovenia and Hungary there are now Labour Force Surveys—in Poland since May 1992 (experimentally since July 1991), in Hungary since the first quarter of 1992 (experimentally since January 1991), and in Slovenia since 1989.

These surveys conform to international standards, and they provide data which is more reliable and easier to process for international comparison. They eliminate the difficulty of cross-country comparisons due to discrepancies between the registration system from one country to the other. Also, the difficulty of comparison in a temporal dimension due to frequent changes in the eligibility criteria of unemployment benefit payments.

Labour Force Surveys showed that Hungary had an unemployment rate of 10.4 percent by the end of 1992, which was lower than the figure computed from the register. However, in Poland, with an unemployment rate of 13.5 percent, no such differential could be observed. In market economies, where both indicators have been available and in use for some time, the survey data tend to be slightly lower. Corresponding statistics have a similar relationship in Hungary, but they differ greatly in the Czech Republic and in Slovakia. In the latter two states, according to preliminary data of surveys, becoming regular only in late 1992 unemployment is significantly higher than the official data calculated from the register (this will be discussed later). In extreme cases the two data may diverge considerably. For instance, official statistics in Russia showed 1.5 percent unemployment early in 1993, while a survey claimed that it was between 4 and 5 percent. Furthermore, a Ministry of Labour estimate gives a figure of 20 million unemployment (*Ginsburg and Student* 1993).

Of course, surveys do not cover those unemployed who have some kind of work, who do not actively seek a job, or who—for some reason—are not available for work, but satisfy the more loosely worded requirements of registration. On the other hand the registered unemployed do not include those who are really out of work but are no longer entitled to benefit, and for this or for some other reason do not find it essential to have themselves registered. This is an important difference between the meanings of the two indicators; it may amount to as much as 1/3 in the countries of the region; this is true even in countries—such as Poland—where the two indicators are close to each other.

In the Western European countries, the growth of unemployment correlates significantly with the decline and slowdown of the outflow (those leaving the unemployment register), and the increasing spells of unemployment (i.e. the lengthening of the unemployment benefit period). In the United States, besides changes on the outflow side, the alteration of the inflow (entering the register) also plays an essential part. In Western Europe, when unemployment grew to a high level across the region, it seemed to be of a long-term nature, and its reduction appeared to take place much more slowly than in the US. This was the case even after the releasing factors were gone (about this labour market hysteresis see *Blanchard and Summers* 1986).

Of course, this new unemployment in our region came about in a special way, and started to rise with the rapid growth of the inflow. The inflow has been at a high level for some time in nearly every country of the region and so far has been

higher than the initially especially low outflow. In 1992, as unemployment kept growing, the difference between the two diminished (at least where there were data available). This was partly a result of the declining inflow, and some growth of the outflow (in Poland, for example, it was due to the rising outflow).

Table 2

Unemployment and inflow and outflow data
(per month, showing the average data for 1992)

	Unemp. rate	Inflow rate	Outflow rate		Outflow rate into emp.	Share of long-term unemp.
		a	a	b	b	b
Czech Lands	3.1	0.6	0.8	25.8	18.0	28.4
Slovakia	11.4	1.0	1.2	9.8	4.8	25.5
Hungary	11.7	0.5	0.5	7.0	3.0	37.3
Poland	14.9	0.7	0.6	4.0	2.3	43.4
Romania	8.3	..	..	1.2	0.9	..

Note: [a]as a percentage of the economically active population
[b]as a percentage of the registered unemployment
Source: Employment Observatory 1992. 1.2., 1993. 3,4. *Blanchard et al.* 1993.

The situation now taking shape in CEE approaches the situation in most Western European countries: i.e. there is a relatively high level of unemployment with a slow turnover, with a large number of long-term unemployed, and an increasing period spent on the register. The apparent difference is that in our region the turnover is slower, the inflow indicators are definitely lower than in Western Europe, and the case is very similar with the outflow indicators. Anywhere where these points can be specified from the available information, the time spent in unemployment rapidly extends. At the end of 1992 the ratio of the unemployed who had been on the register for over a year was above 40 percent in Poland, above 30 percent in Hungary, and just below 30 percent in Czechoslovakia. There is a threat that the hysteresis-phenomena which preserve high unemployment rates will present themselves more strongly in our region than in the Western European countries. This is supposedly related to costraising factors that work towards the reduction of the demand for labour (such as contributions financing unemployment compensation, the raising of minimum wages, or the high level of severance pay), as well as certain other influences.

With regard to the direction of flows, at first there were not so many people as there are today becoming unemployed after leaving their jobs (i.e. mainly those giving up employment by the state and partly on a voluntarily basis). Also, many left the labour market and many others became employed again without becoming unemployed in between. However, very few of those who became unemployed man-

aged to find a new job. Later on, an increasingly large proportion of those leaving their jobs entered the unemployment register. This proportion grew very high in international comparison among all terminations (i.e. of an employment contract). In Poland, taking all sorts of terminations into account (from dismissal to resignation), the number of those entering the register exceeds 30 percent, and only in the Czech Republic is the corresponding ratio below 20 percent. In the overwhelming majority of cases, those forced to seek employment characteristically find themselves experiencing a longer and longer period of unemployment. The chances of finding new employment are fairly low, and new jobs are generated primarily by the private sector. Thus employment depends on the speed at which the private sector can grow (although in Hungary the state sector and the private sector are equal in absorbing the unemployed). However, a significant proportion of those leaving unemployment end up outside the labour market of their respective countries.

The majority of the new unemployed are, more and more, people who have been forced to give up their workplaces—i.e. they are made redundant even if mass lay-offs seem to be rare not only in Hungary. This has been the case in Czechoslovakia, in Hungary, and in Poland since 1991. In the latter, in late 1992 56.4 percent of the unemployed had been dismissed, while the rest had either entered the labour market for the first time (16.9 percent) or re-entered (19.9), had freely given up their jobs (6.8 percent) (*Witkowski* 1993). According to other sources, 56.5 percent of the terminations in 1992 could be ascribed to lay-offs, 26 percent of the cases to unforced resignation, and 18 percent to the giving up of an economically active position. In Romania dismissals have become more frequent since 1992.

Table 3

Long-term unemployment

(the share and rate of those unemployed for at least 1 year at the end of the period)

Year	Czech lands	Slovakia	Hungary	Poland
Share (as a percentage of all unemployed)				
1991	3.9	6.1	13.2	–
1992	17.1	36.3	24.5	30.2
1993 2nd quarter	18.1	32.8	32.3	42.9
Rate (as a percentage of the economically active population)				
1991	0.2	0.7	1.0	–
1992	0.4	3.7	3.4	4.8
1993 2nd quarter	0.4	4.1	3.5	6.7

Source: Country studies; Employment observatory; Labour force surveys (1993)

In Slovenia, where open unemployment has a longer history than in any of the other countries (data go back to 1964), the fast increase of unemployment in the early nineties is attributed to the growth of the inflow, accompanied, moreover,

by a noticeable growth of the outflow. Although the number of those leaving the register for unknown reasons also increased, the dynamism of the Slovenian labour market can be ascertained from the fact that a large number of the unemployed found work. Even in the Czech Republic, significantly more people change their employment status from unemployed to employed, and the outflow rate is altogether higher than in either Hungary or Poland, not to mention Romania. This is, at least partly, due to a more dynamic growth of jobs in the private sector, which in the Czech Republic is starting from scratch.

The fall of employment and labour force participation

In some of the countries the total number of the labour force (economically active population including employed and unemployed/job-seekers) is difficult to determine exactly in accordance with international statistical practice. Even in the other countries it is not that easy to monitor and understand the changes. In Slovenia, for example, from September 1991 to September 1992, employment decreased by 6.7 percent (56 thousand people), while unemployment increased from 9 percent to 12.1 percent (*Drobnič and Rus* 1993). Many people were dismissed through early retirement, but what happened to the others? Or let us just think of the not-yet-independent Czech Republic, where the number of employed decreased by 4.2 percent (210 thousand people) from the end of 1991 to the end of 1992, while unemployment also decreased at the same time (Janaček 1993).

The fall in employment levels was a general and marked trend in every country, especially at the beginning even without closely following the fall in production. At that time, the falls in employment were mainly the result of voluntary separations and a recruitment ban; also, soft measures were used, such as putting an end to the employment of retired people, or introducing early retirement schemes (which in a few countries had major effects). In Slovenia and Poland early retirement accounted for 70 percent of the cutback of employment levels in 1990; in the Czech Republic it had affected 70,000 people by the end of 1992. At the beginning, lay-offs on the grounds of discipline contributed to a shrinkage of employment figures. Then, in fits and starts, came the loss of jobs, and the subsequent unemployment became the major cause of the decline of employment statistics.

In the background of the reduction of employment it has often been encountered that people retreat or are pushed out of the labour market. As a consequence, labour force participation has also usually suffered a setback. The effect of such setbacks have worked differently in their nature and intensity from country to country. They have mainly hit the age groups close to retirement age or above, in some countries women, young people reaching working age, or those living in villages.

A good number of people were simply "pulled out" from the official labour market. This is how a part of the significant drop in the labour force participation rate (i.e. the ratio between the number of those in employment and waiting for employment on the one hand, and those of working age on the other) in Czechoslovakia, in Slovenia, and in Hungary is certainly no more than an appearance. Many people working in small private sector companies or in the informal economy were left out of the statistics.

Table 4

Labour force participation rates
(as a percentage of the working age population)

Year	Czechoslovakia		Hungary	Poland
	Czech lands	Slovakia		
1989	84.8		82.5	76.1
males	87.0		85.9	83.6
females	82.3		78.8	68.6
1992	78.8		78.4	74.5
males	85.7		78.8	80.7
females	71.4		78.0	68.2
1992^S	65.4	67.8	73.2	69.0
males	72.4	77.9	77.0	76.1
females	58.5	57.5	69.5	62.1

Note: according to country by country definitions of working age for males and females
^{S}according to Labour Force Surveys
Source: Country studies; Employment Observatory; OECD-CCET Labour Market Database

With regard to the changes in the branch and ownership structure of employment, the decline of industrial, construction and agricultural employment and the strengthening of the service sector are general phenomena. Also, the state and cooperative sector has lost ground; employment has increased fastest in the private sector, while private enterprises have proliferated more in the services and trade. In Hungary, in Poland, and in Slovenia the decline of employment in the state-owned sector has been more strongly felt, but it is in these countries that employment in the private sector has grown dynamically. In the Czech Republic there was some delay in the shrinkage of state sector employment, and it has only taken place to a limited extent. However, starting from virtually nothing, private sector employment has started to rise rapidly. In Slovakia, a more intense reduction of state sector employment alongside a weaker private sector has brought about a less favourable employment situation. In Romania, the delay in economic

transformation, despite drastic falls in production, coincided with the delay of the reduction of state sector employment. The economy, as well as the employees, have had to pay an expensive price for this, since the currently high inflation and very low consumption are compounded by high unemployment.

The fall in state sector employment has so far been very loosely related to the sectoral shift of employees of state-owned companies in connection with processes of privatisation. Also, the increased significance of the private sector from the point of view of employment is not due to this, but primarily to the proliferation of brand new private enterprises. These are typically small or medium in size, and it is not rare to find that they increase employment figures through uncertain, low-standard, low-paid jobs. It is not surprising to see that the private sector not only increases employment, but equally fuels unemployment. The majority of the people employed by the private sector have come directly from the state sector without experiencing unemployment in between. Where it is possible to trace details with the help of household panels, one can find evidence that the private sector actually employs less unemployed than it "produces" (*Köllő* 1993).

The reductions in the state sector are surely and reliably documented, in contrast to the *unreliable* estimates on private sector employment. In Hungary, in mid-1993, the share of the private sector in employment was 38 percent with respect to fully private ownership, and 49 percent if we add partial private ownership as well (*Kolosi* 1993). Between late 1991 and late 1992 the proportion of private sector employment, (alongside falling overall employment) grew from 15.7 percent to 17.2 percent in Slovenia, from 17.6 percent to 27.8 percent in the Czech Republic, and from 47.2 percent to 58.4 percent in Poland. In Slovakia 20 percent worked in the private sector at the end of 1992 (*Schmögnerová* 1993). Other studies offer different figures, also inadequate for reliable comparison. See the employment structure data in *Table 5* derived from another paper. (Blanchard et al. 1993)

Selectivity and regional differences in unemployment

In the Central Eastern European transition economies the unemployment is no different from that which has evolved in the market economies over a longer period. In other words, it threatens certain well-defined groups of the population disproportionately and in a selective way; maybe this process is even more ruthless than in Western Europe.

The unskilled and underqualified are considerably over-represented among the unemployed in all five countries. The unemployment level of those with highest qualifications, on the other hand, is well below the average. In the Czech Republic, at the end of 1992, people with an elementary education constituted 20.6 percent of the total active population and as much as 37.8 percent of the unemployed; cor-

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Table 5

The share and evolution of state and private sector employment (percentage)

Year	Czech lands	Slovakia	Hungary	Poland	Romania
1990					
State	91.9	95.1	–	66.4	–
Private	8.1	4.9	–	33.6	–
1991					
State	80.1	87.2	66.0	59.7	93.1
Private	19.9	12.8	34.0	40.3	6.9
1992					
State	70.0	83.0	64.2	55.6	88.0
Private	30.0	17.0	35.8	44.4	12.0
1992/1990					
State	84.0[a]	77.6	66.0	79.7[b]	90.2[c]
Private	111.3[a]	109.6	121.0	107.7[b]	104.4
Total	92.5	87.6	87.7	87.4[b]	96.1

[a]1991/1990
[b]1992/1989
[c]1992/1991
Source: Employment Observatory 1992, 1993; Blanchard et al. 1993; Country studies

responding figures for those with higher qualifications were 10.8 percent and 2.6 percent, respectively. In Poland, those with a primary education represent 23.5 percent of the unemployed and their unemployment rate is 12.7 percent; skilled workers make up 40.6 percent of the unemployed contingent and their unemployment rate is 16.9 percent; however, those with university degrees constitute 3.6 percent of the unemployed and their unemployment rate is 5.3 percent (Witkowski 1993). The situation in Romania is similar: 2 percent of the unemployed have been through higher education, while 88 percent of the unemployed consists of workers with a vocational training, which was very easy to obtain under socialism (*Miron* 1993).

As far as age is concerned, the youth run a higher-than-average risk of unemployment in Poland, Czechoslovakia and Romania; the unemployment rate of those in the 45–50 age range usually falls below the average. At the end of 1992, in Poland 30 percent of the age group below 25 was unemployed; in Romania, at the same time, more than the half of the registered unemployed were under 30. According to some Slovenian calculations, the risk of unemployment is in reverse proportion to the age of the subject, while Hungarian statistics suggest that young people face no more than an average of unemployment.

In the majority of the studied countries, the situation of women is worse than average. In most cases the unemployment rate for women is much higher

than that of the male population. In Poland, for example, the unemployment rate of the latter was 12.7 percent, that of the former 15.9 percent at the end of 1992. According to Slovenian statistics for 1992, women are less threatened by unemployment, a fact attributed by the authors (Drobnič and Rus 1993) to the nature of the economic crisis and the resulting collapse of certain branches (heavy industry, energy production) and the concomitant shutdown of plants which employed mainly male labour. Hungarian figures for the period between March 1991 and March 1992 (Köllő 1993) similarly indicate that the risk of unemployment is much smaller for women than for men.

As for minorities and ethnic groups, the Gypsy population is the group that is threatened most. Great numbers of this group, of considerable size in some countries, are crowded out of the labour market owing to their low level of education and lack of vocational training. High unemployment in their case (the rate of unemployment among gypsies is around 50 percent in Hungary according to survey data (*Nagy and Sík* 1993) is obviously due to the accumulation and compound effect of the factors mentioned above. The size and details of the problem, which appear together with serious regional differences, are difficult to grasp even in Hungary where targeted research has already started. Much less is known about countries like Slovakia and Romania, although they face the same problem.

Unemployment statistics illustrate striking, often extreme territorial disparities, and these show signs of persisting in all countries of the region, from the smallest to the largest. Territorial disparities in terms of unemployment are definitely larger in transition economies than in market economies, while at the same time the constraints on geographical mobility—as a result of housing conditions and of practices developed by the planned economy—are much stronger in comparison with the United States and even in Western Europe.

In Poland the rate of unemployment is higher than 25 percent in 6 voivodeships while in Hungary it exceeds 20 percent in four counties. In Czechoslovakia differences between units well above county size were smaller; at the end of 1992, in Slovakia, the highest rate was about 12.5 percent in Eastern Slovakia, while in the Czech Republic it was 4 percent in Northern Moravia. In Romania the highest rates are to be found in Moldova; in mid-1993 in one county the unemployment rate was above 28 percent, and in two counties it was around 20 percent (*Vincze* 1993).

If we consider smaller units, such as the Hungarian labour placement districts, much bigger differences can be assumed. At the end of 1992, in 10 out of the 176 Hungarian placement districts, the registered unemployment rate was found to stand at over 33 percent. In Slovakia, among 38 districts unemployment was around 20 percent in two districts, five districts had figures of between 17 percent and 19 percent, and seven districts had statistics which in 1993 exceeded 20 percent (*Employment Services Dept.* 1993). In units similar in size than the Hungarian units, one can find even higher rates of unemployment. In the Czech Republic,

unemployment rates were high: 9 percent in the Pribram district and in some Northern Moravian districts.

The regions most threatened by unemployment in all countries include regions with a unilateral economic structure based on some declining branch of the heavy, textile or sometimes electric industries (such declines have played an outstanding role in the deterioration of employment in Slovakia). This is also true for engineering, for mining areas, and certain agricultural regions. Serious problems have their roots in the former "citadels" of socialist industrialisation, where one or another large state company plays a determining role in employment.

Differences are related to the circumstances of a shared past (nationalisation, socialist industrialisation, agricultural collectivisation) and a shared present (decline of state-owned industry, the reduction of employment). In explaining the discrepancies of unemployment—and going further than the fall in industrial production and employment levels—we can only refer to Hungarian investigations. These provide plausible explanations which push into the foreground the role of family-wealth, private savings and investments, the number of small enterprises (Köllő 1993), entrepreneurial capacity, the quality of arable land and the levels of income (*Fazekas* 1995). It is clear that from the outset, the following factors will fragment the present labour markets and shape the newly emerging ones: large territorial differences, the uneven distribution of the risk of unemployment, discriminative dismissal and recruitment practices, marginalisation or squeezing out of significant groups of employees from the labour market, the institutionalisation of fragile, legally unprotected forms of employment, the transformation of economic governance and organisation into a market-structure, and the temporary desorganisation of the economy. This process may be seen to run parallel with the experiences of market economies, the theoretical approaches (*Piore* 1983; *Becker* 1971) of which have been described in terms of growing labour market segmentation and discrimination against cultural, ethnic or other minorities in periods of increased unemployment. Of course, it would be premature to say whether these—so far—hardly defined processes taking place in the countries of CEE are similar to those of their more sharply contoured Western counterparts.

Active and passive labour market policies

Measures and institutions which combat the economic and social consequences of unemployment have been established in a hurry (albeit with some delay) in every country of the region. This has been done by adapting structures commissioned over decades in market economies. This is how it has become inevitable to modify frequently the passive and active measures that have been introduced.

Related expenditures grow in proportion to the increase of unemployment. In Hungary the proportion of total expenditure on all active and passive employment measures, ranging from benefit payments to job creation to the GDP, has more or less reached the average level in OECD countries. In other countries of the region, even in Poland, it lags behind this level for the time being (calculations: Köllő 1993).

Table 6

Expenditures on employment policy over time
(as a percentage of GDP)

Year	Bulgaria	Czecho-slovakia	Hungary	Poland	Romania
1990	–	–	0.4	0.6	–
1991	0.6	0.6	1.2	1.6	0.3
1992	0.9	0.9	3.0	2.0	0.8

Note: GDP data cannot be fully compared with each other; in several countries the data are not directly comparable to OECD country data.

The expenditure level (which has been reached within a short period of time) relates to an unemployment level which exceeds the average of the developed market economies, and is still on the rise. In the respective countries this expenditure stands alongside declining GDPs and rising budget deficits. Thus the fight against unemployment to avoid intolerable tension and the threat of social explosion, may itself lead to an unacceptable level of budget deficit and to over-taxation. This, in turn, may negatively influence labour demand, and may contribute to the formation of hysteresis phenomena that extend the duration of high unemployment. The threat inherent in such a situation has been recognised not only in Hungary—where unemployment benefit has been the most generous, and where (besides the central budget) direct contributions by employers and employees related to the same are the highest—but in other countries of the region as well.

It is not by chance that, ever since 1991, the newly introduced system of unemployment benefit payment has been modified at least once in Poland, Czechoslovakia and Hungary to become stricter and more severe. The reason is that these payments are usually the largest single item of expenditure (making up, in Poland, 51 percent of all expenditures in 1990, 82 percent in 1991 and over 87 percent in 1992, which is even more than the approximately 71 percent in Hungary).

Czechoslovakia saw the most spectacular cutback. The 1989 system offered a benefit corresponding to 95 percent of the net income of those dismissed for reasons of reorganisation for six months, and 60 percent for another six months, while everyone else received 60 percent. The 1991 system restricted eligibility to

those who had worked, studied, or completed military service, or who had been on sick or maternity leave for at least 6 months during the two previous years. The amount was 60 percent of net income for the first six months and 50 percent for another six months (these replacement ratios were temporarily raised to 65 percent and 60 percent, respectively). In 1992, eligibility was limited to those who worked, did military service or took part in school education or vocational training for at least twelve months in the previous three years. The time span of the benefit was limited to six months, with a compensation of 60 percent in the first half of the period and 50 percent in the second, and 70 percent throughout the whole period for those who took part in retraining. The benefit must not exceed Kc3000; there is no compulsory minimum. Serious measures are taken against those who do not cooperate adequately with the employment office.

Elsewhere—even after modifications—the possible maximum period of unemployment benefit remained longer: e.g. 9 months in Romania, 12 months in Poland, and in Hungary in 1993 it sank from 18 months to 12, closer to West European practice. In Poland, however, in 1993 it was decided that in crisis areas the benefit would be payable for up to 18 months. There is usually a set minimum of the benefit: this is 40 percent of the minimum wage in Romania, 80 percent in Slovenia, 90 percent in Bulgaria, 96 percent in Hungary (not anchored to a minimum wage), and in Poland the benefit and the minimum wage have been virtually equal since 1992. The maximum amounts of the compensation have been adjusted downward in other countries as well, and the eligibility has also been restricted. Thus the excessive generosity of the benefit system (i.e. by European standards) is about to disappear. The majority of those on benefit receive the minimum, and the average benefit is close to the minimum wage, or has fallen below it (in Hungary it was 42 percent of the average wage at the end of 1992). Those who are no longer entitled to unemployment benefit can apply for a lower social benefit. In Hungary it is set at 80 percent of the minimum pension (this amounts to about 50 percent of the minimum wage; at the end of 1992 the average sum paid out was 20 percent of the average wage), in Romania it is 40 percent of the minimum pension, and it is payable for 18 months. In Slovenia up to three years from the beginning of unemployment compensation a social benefit equal to 80 percent of the minimum wage is available. Similar assistance is available in the other countries, also worked out on a type of means-tested basis.

Of course, comparison of the benefit systems with respect to their frequently changing general rules is of limited relevance. On the one hand the unemployed may receive benefits on the basis of different criteria, which happen to be in force at the start of their unemployment. On the other hand, only some of them are payed according to the general rules [e.g. 25 percent in Hungary by the end of 1992 (Nagy and Sík 1993)]. The others—i.e. the majority—get the minimum. Limiting the conditions of eligibility, shortening the period of benefit payment, reducing the amount payable, and the expiry of the entitlement for the long-term unemployed,

Table 7

Breakdown of expenditure on active employment measures
(as a percentage of the total)

	Czechoslovakia	Hungary	Poland	Romania	Slovenia
(Re)training					
1991	6.9	17.8	58.7	5.2	25.0
1992	7.0	22.3	69.2	3.8	21.5
Job creation					
1991	61.6	24.9	20.4		3.5
1992	76.2	33.5	22.5		13.5
of this:					
public work					
1991	14.4	8.2	–		
1992	11.3	12.8	6.1		
communal, social					
1991	47.2	–	20.4		
1992	64.9	12.8	16.4		
Employment subsidy					
1991	–	2.2	–	87.1	35.0
1992	–	6.8	–	81.7	50.0
Assistance to new enterprises					
1991	17.1	41.2	18.2	0.5	4.0
1992	4.5	18.5	8.3	1.1	
Employment of young people					
1991	4.8	–	–	2.3	
1992	7.7	0.1	–	3.2	
Assistance to long-term unemployed persons					
1991	–	0.3	–	–	
1992	–	2.5	–	–	
Employment of persons with changed working abilities					
1991	0.5	–	2.7	1.8	
1992	1.4	–	–	3.3	
Regional programmes					
1991	–	4.3	–	–	
1992	–	8.1	–	–	
Early retirement					
1991	–	5.4	–	–	25.0
1992	–	5.8	–	–	12.0
Reduced working time					
1991	7.3	–	–	–	
1992	2.9	–	–	–	
Other					
1991	1.8	4.2	–	3.0	7.5
1992	0.3	2.7	–	1.9	3.0
Total					
1991	100.0	100.0	100.0	100.0	100.0
1992	100.0	100.0	100.0	100.0	100.0

Source: Employment Observatory (1993) No 4., Country studies

Note: Due to differences in contents the above data cannot be compared with full reliability

has resulted in the reduction of the number of those receiving unemployment benefit. In Poland this ratio was 75 percent in 1992, but it had come down to below 50 percent by 1993; in December 1992 the comparative figure in Romania was over 60 percent, but by mid-1993 it was only 48 percent; and in Czechoslovakia a mere 38 percent of all registered unemployed received any benefit by the end of 1992. By mid-1993 Slovakia had made its ratio even lower—33 percent—while the same indicator stands at 45 percent in the Czech Republic.

The change and spread of the unemployment benefit system in Czechoslovakia was strongly related to the changes in unemployment, and in the changes of the expenditure structure (which was very different from the structures in other countries of the region). In 1992, alone in the region, Czechoslovakia's share of spending on active measures grew to 65 percent. They spent a great deal more on creating what they called "socially purposeful" jobs than on passive measures. Part of the very dynamic increase in 1992 was due to the fact that the assistance—ranging from job creation offered by companies to the self-employment of the unemployed—was increased to Kc 50,000 per person employed. (In Slovakia, for instance, the number of jobs so created in 1992–93 rose from the previous year's figure of 24,436 to 115,976.)

The other country where more money is spent on active employment measures is Slovenia. The relatively wide range of active employment policies (almost 60 percent of all expenditure) is at least partly explained by the fact that it is not a new practice. 28,000 people took part in various training and re-training programmes at their workplaces and elsewhere (this corresponds to nearly one third of the total number of the unemployed). The second largest item after unemployment benefit is the subsidisation of wages. These are allocated to those enterprises staggering under the burdens of transformation, but which offer competitive programmes and productive employment to help them preserve their existing jobs. In 1990–91, income allowances associated with early retirement played a rather significant role. This, in turn, led to an unprecedented rise in the number of pensioners. Interestingly enough, instead of mobilising the underqualified manual workforce, Slovenian public work programmes mostly involve people with secondary or higher education. They are provided with social, administrative, cultural and similar tasks appropriate to their qualifications, and a salary ranging from 80 percent of the minimum wage to 70 percent of the usual wage for the given activity.

The role of retraining and training is, at present, on a minor scale in every country in the region. One reason for this is the fact that in none of the countries concerned can the vocational structure requirements of the much anticipated transition be determined. In some countries—e.g. Hungary—these training programmes were, at first, mostly occupied by people in employment, rather than by the unemployed. Only in Poland did they allocate most of the otherwise very low active expenditures to training programmes; the money was primarily used to avoid or

reduce the likelihood of unemployment among young people, including those who were about to complete their regular education.

Besides Czechoslovakia, Hungary was the other country where job-creation was a major target for expenditure. At first, the main aim of this was to ease local tensions. Then, in 1992, the emphasis was shifted over to promoting the employment of disadvantaged groups of employees, to providing temporary employment to the under-educated, and to the long-term unemployed. With regard to explaining the limited use of public works programmes, and more important factors than the lack of financial resources, are the limited organisational skills of the local governments and the lack of additional funding that they have been able to mobilise. Early retirement is underused as a means of easing the problem, in comparison to Western Europe and to the Eastern Lands of Germany. Slovenia and Hungary are the two countries where noteworthy programmes are underway to preserve existing jobs. In the meantime, in Romania, the largest proportion of the very low spending on active measures is allocated precisely for this purpose. Relatively, a large amount was spent in Hungary on encouraging the unemployed to start a business. This encouragment was in the form of an interest subsidy for a launch credit. However, the scheme worked with doubtful efficiency and has since been abandoned.

Employment policy and economic policy

Unemployment and the success of the fight against unemployment in the Central and Eastern region obviously do not depend exclusively on the employment policy, or on the choice of active and passive employment measures, or on the proper definition of objectives and of the target groups. They are also influenced by the general shape of the economy, and the broader context of economic policy.

Even if the respective employment policies were in complete match with the situation, and if hysteresis-phenomena did not hold up a favourably oriented change, the short-term reduction of unemployment can only be expected in those countries in the region that are more advanced in terms of their employment fall, unemployment pattern, and the progress of their economic transition. Also, the reduction of unemployment depends on stopping the fall in production and ensuring the take-off of economic growth. On this basis, Poland, which plunged first and deepest into turmoil yet showed palpable economic growth as early as 1993, should be the first to see the tensions reconciled. Nevertheless, its interim statistics reflect a further growth of unemployment. This also contradicts the argument frequently advanced in the case of Poland, whereby the abandonment of the restrictive economic policy (shock therapy which was held responsible for the sudden plunge in the demand for labour) was expected to bring about almost automatic recovery in the labour

market. This has proved not to be the case, indicating that the demographically induced oversupply of manpower should also be blamed. The growth of unemployment has not stopped in Slovenia either, despite the gradual easing of the downward trend in production, the moratorium announced on bankruptcies due to insolvency, the replacement of collective agreements with administrative wage control in 1993, and other economic policy measures which had raised hopes that the surge in unemployment after the big wave of plant closures in 1990–91 would come to a halt. At the same time, in Hungary, with production figures perhaps somewhat more favourable than those in Slovenia (but not as good as in Poland) unemployment started to come down slowly in the spring of 1993.

The Czech Republic has now arrived at the critical phase of economic transition; as consequences of the economic policy measures (bankruptcy legislation, full-fledged privatisation), shrinking export demand and a number of other factors foreshadow the worsening of the currently encouraging unemployment statistics. However, other economic policy measures seem to counterbalance these bad points; for instance, the restricted and shortened unemployment benefit payment and a wide range of active employment measures. Registered unemployment is still quite low, but an unusually higher rate derived from recently introduced Labour Force Surveys represents a tentative indication of the growing tension. In Slovakia, despite an employment policy similar to that in the Czech Republic (albeit alongside less promising economic conditions), the unemployment rate has been a great deal higher; in fact, it has risen further, thus justifying pessimistic forecast, and agreeing with those studies which predict further significant rises.

In cases in which no deeper insights have been provided into the situation, we may only refer to an unprecedented dive in the production figures and a setback of demand triggered by recession when seeking an answer to the irresistible advancement of unemployment. On this basis, in Romania, where production has fallen very sharply (and has probably not yet reached the bottom of trough) and at the same time essential economic changes are still waiting to be implemented, a further considerable growth of unemployment can be anticipated.

The current high unemployment in every country of the region is beyond doubt related to the shrinkage of overall demand—i.e. the fall in demand on the commodity market and on the labour market. Tensions on the labour market would increase if demand-restricting policies, the low level of overall demand would be complemented by a significant restructuring of the production system.

It is not so obvious that improvement would take place in the reverse case: i.e. if the constraints on demand were reduced or if they disappeared altogether. In reality, the elimination or the relaxation of the restrictions would have a contradictory effect on employment and on unemployment, even if economic growth were to take-off. It may, on the one hand, trigger the expansion of employment, by letting demand grow; on the other hand, it may ease and speed up the restructuring necessary to get over the crisis and bring about modernization of the economy. Yet

by doing so it could again contribute to the growth of unemployment. In reality, the issue is evidently a great deal more complex than that, and it should not—even from a research point of view—be simplified to this particular dilemma of economic policy. However, at the same time, in several countries the right way of phrasing the pertinent questions is not yet even known due to the absence of the required macro- and microeconomic analyses.

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REFORMING ALLIANCES: LABOUR, MANAGEMENT, AND STATE BUREAUCRACY IN HUNGARY'S ECONOMIC TRANSITION

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This paper analyzes the evolution of the relationships between workers, managers of public enterprises, and state bureaucrats in Hungary before and after the political regime-change. Focusing on the impact of these changing relationships on economic reforms, the paper compares the reform strategies of the late-Kádár regime with those of the first democratic government.

The worse economic conditions inherited by the Antall government did not allow for the same level of use of the public economy for short-term political goals as had been pursued during the Kádár-regime.

Introduction: three approaches to transition politics

Much of the debate about economic transition in East and Central Europe concerns the search for salutary relationships between workers, managers of public enterprises, and state bureaucrats. *Statist approaches*, independently of whether they believe in the transformative capacities of the state or the market, stress the importance of empowering state bureaucrats, insulating them from special interests and giving them exclusive control over the process of economic transition. According to this approach the key aspect of transition politics in the sphere of industrial relations is the political neutralization of workers and managers. The proponents of *negotiated transition*, however, hold that all the major economic actors should be empowered, and that the key to the success of transition politics is the establishment of effective negotiating mechanisms, including, among others, the integration of key economic actors into the formation of transition policies. Finally, students of the *political economy of reforms* would caution against general propositions, and would stress that although insulating state bureaucrats from group interests might promote the initiation of economic reform, for the consolidation of reform it is crucial to establish a broader political basis for transition by forging alliances between the key economic actors. This paper provides an analysis of the evolution of the relationships between key economic actors in Hungary before and after the political regime-change. Focusing on the impact of these changing relationships on economic reforms, the paper compares the reform strategies of the late-Kádár regime with those of the first democratic government. The first part of the paper briefly surveys the above-mentioned three approaches to the question of how the relationships between the key economic actors are supposed to be transformed in order to attain

successful economic transition. The second part presents an overview of the way in which relationships changed between labour, managers and state bureaucrats during the state-socialist regime and under the first democratic government. The final part of the paper draws some preliminary conclusions based on a comparison of the reform strategies of the two regimes.

Let us begin by examining the *statist marketization* approach, which is currently the most popular in Eastern Europe. A simplified version of this approach suggests that successful transition can be achieved by the following changes in the relations between economic actors: first, the representatives of the state, who are in charge of the economic transition, must be protected from the influence of any partial interest coming from parliament, political parties, or any union or special interest group. These representatives would have powers of extended control, and would have the task of transforming the economy according to a coherent blueprint, in order to create from above new classes and to establish new relations between the main economic actors. The employers (primarily heads of state enterprises) either have to be turned into owners, or real owners have to gain control over them—naturally, according to a process controlled by the state. In this scenario, the labour force has the option of becoming wage-workers, self-employed entrepreneurs or unemployed. In this approach, the managers pay continuous attention to the interest of the state and have something of an autonomous role; however, labour must be politically neutralized by the permanent activity of the "Ministry of Carrots" or the "Ministry of Sticks", the choice here would depend on the money left by financial secretaries or foreign investors in order to finance social peace.

This approach has its own sociological and even philosophical foundations. According to the main sociological approaches which have contributed to the intellectual establishment of etatist marketization, the societies of Eastern Europe are too homogeneous. Hence, economic liberalization would create a number of losers, who would then become the potential political opponents of such a process. On the other hand, there is no large and/or powerful social class which could serve as a basis for marketization and democratic rule (*Staniszkis* 1989). From this vision of society a picture logically arises whereby the economic transformative power of the state is a function of the weakness of civil society. As far as the philosophical component of this approach is concerned, it is an irony of history that Marx has now been turned on his head. Marx, unlike Hegel, considered the working class to be the representative of universalism, and every other state or class to be representatives of particularism. Now, in good old Hegelian fashion, the state is again seen as the representative of universal considerations, its mission being to lead society into a happy future, even against the particularistic interests of the different social groups. There are variations on this approach, of course, in which Marx would rather be turned on his back or his front. These views do not consider the state in general, but rather the technocrats (or in some versions, the class of entrepreneurs) to be the representatives of universal interests. These opinions suggest that the

key to successful economic transition involves maximization of the political roles of technocrats or entrepreneurs.

In opposition to this approach of etatist marketization many alternative views have been formed in recent years. The first, the approach of *negotiated marketization* suggests exactly the opposite from statist marketization: in other words, only if the internal relations of the economic actors and the relations between the state and society in general are turned into a cooperative, positive sum game, can the economic transition be implemented in parallel with the concomitant serious social burdens, AND the consolidation of a democratic order. According to this approach, too rigid blueprints could be highly dysfunctional since economic transformation involves a complex social and political learning process. Moreover, because of the significant political and economic risks, all three participants should grow powerful and establish strong interest representation. The negotiating, consensus-seeking policies of their representatives should also coordinate the economic, political and social aspects of the transition. In this approach the primary tasks of the governing elite are: to define the broad circle of issues which should be discussed in consensus-oriented negotiations; to establish the political conditions for a political consensus including the parliamentary parties and the extra-parliamentary unions by creating economic and social pacts; and to bring about an institutional network which can regulate the conflicts of the transition in a consensual way at both the micro- and the macro levels.

The sociological support for negotiated marketization cames from, among others, the representatives of that sociological school which asserts that the societies of Eastern Europe are not homogeneous but are rather heterogeneous, where each social group can be characterized by multiple economic, cultural, political and network capitals (*Szelényi* 1988). The representatives of this approach would say that the majority of people in these societies would not automatically be losers and thus the enemies of marketization. For them, the key issue is to avoid a situation in which social groups, which could theoretically find their place in the new economic system, become enemies of reforms. The goal is to integrate those groups from the old system, which have weaker resources and capital, and find ways of accommodation for those who possess more and varied types of resources. In other words, the task is not to insulate bureaucrats from politics or to implement foreign models from above. According to the supporters of negotiated marketization, such state intervention would be just as harmful as a nightwatch-man in a china factory who drunkenly hits everything he can with his stick. The purpose of the micro-, mezo-, and macro level discussions and the negotiated, consensus-seeking economic transition would be to protect the already existent resources and capital in the transition and to transform them according to the considerations of economic rationality and political stability. The philosophical supporters of negotiated marketization would say that Marx and Hegel can walk out of the picture hand in hand. No one represents universal interests alone, for each participant enters the

transformative game with particular interests and considerations. The task is to create mechanisms which make it possible to synthesize particular viewpoints and rationalities. This does not mean that the state and the government itself should not outline more general economic and political considerations. Rather, it means that more general political and economic considerations can only be implemented through negotiations with parliamentary and extra-parliamentary organized forces, and that transformative politics should not be formed solely according to a preconceived scenario, but to a series of economic and social pacts and agreements.

Finally, a third approach has also been formulated in recent years, which focuses on the *political economy of reforms*. It is partly a result of studying Latin-American and other Third World poor capitalist economies and weak democracies, and partly as a consequence of the first failures of East-European transition politics (*Nelson* 1989, *Haggard and Kaufman* 1992; *Przeworski* 1991; *Comisso, Dubb and McTigue* 1992). Although its basic normative standpoint is similar to the second school, this approach asserts that there is no scenario that can be generalized as a model for successful transition, and that the general recommendations should be applied on a case by case basis. The countries of the region have arrived at their new situations with different histories, social structures, economic institutions, political systems and cultures. In addition, the internal stratification and organizational capabilities of employers and managers differ by country and the relations among economic actors are also significantly different. Moreover, there are important variations in the possibilities for different policies, given each country's external economic and political conditions and relations. In other words, each country can be characterized by different constellations of external and internal inhibiting factors and resources. Only after familiarizing oneself with these variations can one understand what type of internal economic relations among employers, labour and the state will contribute most to a successful economic transition. According to this approach, the first things that must be studied are the different characteristics, institutions, resources and internal relations that the different economic actors have carried with them to the new system. The second phase of the examination should concentrate on how the relations between these actors have been modified by the policies of new governments and how these relations have affected the conditions of economic rationality and the maintenance of social peace. Only after all of these elements have been observed can one reach conclusions and make suggestions concerning the question: "What is to be done?"

Below, I would like to reflect on some of the issues raised above by comparing the interrelationships of the economic reforms and strategies used to manipulate the relations of the key economic actors under the Kádár regime, and the tactics applied for the same purpose by the first democratic government in Hungary.

Workers, managers and state bureaucrats in transition

The transformation of the working class in the Kádár regime

The previous system in Hungary used a unique mixture of economic and non-economic measures to co-opt labour and neutralize it politically. In the Kádár-era, labour was integrated into a bargaining system which stretched from the Political Committee down to the workshops. Through this integration, based on paternalistic networks, workers gained periodic wage increases, improvements in social welfare and relative autonomy from the party-state. From the 1960s, this paternalistic bargaining system was accompanied by the first—albeit hardly tolerated unofficial, but in the 1980s partly institutionalized—market mechanisms and institutions. Altogether this made up what became the largest second economy in the state-socialist camp. (Gábor, R. 1986, Stark 1986). This mixed system resulted in the formation of very stratified social layers. While the upper 10 percent of the so-called "working class" had already begun to turn into entrepreneurs in the old system, the majority tried to improve their situation by combining a main job within the sphere of the official economy with some form of participation in the second economy. At the bottom of the hierarchy were those who did not have any kind of marketable resources or good bargaining positions within the public sector. They existed as wage workers in the classical sense, dependent on the will of directors, and without any interest representation.

This economic and political heterogeneity limited the establishment of workers' interest-representation in a significant way: in an East-European comparison, the Hungarian workers "arrived" at the new regime with the highest number of market institutions and the weakest and most divided trade unions. At the macro level they did not have any organization which could actively participate in the formation of transition policies. At the level of enterprises workers had very shaky bargaining positions, based mainly on the strength of a policy of full employment and other characteristics of the old system. The latter included such features as the soft budget constraints of enterprises, and the chaotic bureaucratic relations surrounding Hungarian enterprises; these forced managers to carry out special bargains with the most important groups of labour (*Sabel and Stark* 1982).

The rise of managers and the fall of the party-state

Managers of public enterprises arrived at the new regime in a better position because of their positions in the old system, and primarily because of the dual function they had during the Kádár era (*Bauer* 1976; *Kornai* 1980; *Szalai* 1989). On the one hand, they were the local political commissioners of the system, in

charge of delivering those "political goods" which were considered important by the central bureaucracy of the party-state for maintaining political stability and social peace.[1] On the other hand—and this was an exclusively Hungarian phenomenon for a long time—the party-state also treated the directors of the enterprises as the agents responsible for economic rationality.

By fulfilling their *political functions*, managers became part of the paternalistic bargaining system, in which positions in the struggle for scarce resources were determined primarily by non-economic factors. Managers of the most important public enterprises were, moreover, coopted onto the higher decision-making bodies of the party-state, gaining influence, if not control over the strategic decisions affecting the growth possibilities of their enterprises (*Csanádi* 1986).

At the same time, during the recurring waves of reforms, the managers of public enterprises as *agents of economic rationality*, periodically gained more and more control over property. Furthermore, their contrasting functions strengthened rather than weakened their overall position. As agents of economic rationality they could enjoy growing economic autonomy, which only further improved their bargaining positions as suppliers of "political goods" for the party state.

None of this implies that relations between managers and the state bureaucracy were devoid of ambivalence. The basic interests of those party-state organizations—mainly the regional and local party committees and the branch ministries—which were responsible for controlling the production of "political goods" necessary for maintaining political stability and social peace, were obstructed by managers' increasing economic autonomy.

At the same time, those parts of the party bureaucracy which were responsible for macroeconomic rationality and economic balance—meaning central ministries such as the Ministry of Finances, the Planning Office and those departments of the Central Committee which were responsible for economic equilibrium—supported the increased economic autonomy of managers; however, they considered the managers' political functions and their bargaining positions based on their non-economic performance as a main source of economic problems.

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[1] The political functions of public enterprise' managers originated in the softening of the authoritarian features of the state socialist regime. After the 1956 revolution, it became a political priority for the Kádár regime to continuously increase the level of consumption, and *thus* it became one of the major tasks of the branch ministries and local party organizations to squeeze out of the public enterprises and cooperatives the goods thought to be politically necessary for maintaining the "high level of satisfaction" of the populace. Thus, substituting for market mechanisms, these agencies of direct control functioned like imperfect mediators between supply and demand. In exchange for delivering these political goods, or "political crops", as they were called in the agricultural cooperatives, the managers could bargain for more resources, and/or participation in the formation of the plan directives of their firms. Besides delivering such political goods, public enterprises also had several "social functions" too, including the maintenance of the level of employment in the given territorial unit. Needless to say, the execution of these "social functions" further increased the bargaining positions of public enterprises.

While the dual functions of the managers contributed to the improvement of their economic and political positions, the same duality was the source of division inside the party-state bureaucracy (*Bruszt* 1988, Szalai 1989). In principle, this was the tension between economic equilibrium and social peace.[2] In practice, it was the tension between party and state agencies responsible for economic growth, and the agencies responsible for political control. While the former struggled for the extension of market relations, the later struggled for the extension of their discretionary redistributive rights.[3]

Economic and social tensions strengthened different wings of the party bureaucracy. The growth of economic imbalances supported the technocratic wing of the bureaucracy; during such periods there were attempts to weaken the political bargaining positions of managers while simultaneously increasing their economic autonomy. On the other hand, when the party leadership became afraid of the potential increase in social tensions, they tried the other way around—i.e. improving managers' political bargaining positions and reducing their economic autonomy.

The heightened economic difficulties of the 1980s practically paralyzed the different wings of the party bureaucracy representing their respective rationalities. Due to the fear of growing economic imbalance, managers' economic autonomy spread and, by the beginning of the transition, the managers practically possessed all the major institutional, if not legal means of control over public property. At the same time, increased concern with economic imbalances did not strengthen the technocratic wing of the party state enough to enable it to significantly reduce managers' political bargaining positions. The only fear greater than the fear of economic collapse was the fear of an explosion of social tensions, i.e. the fear of society. This fear helped to preserve the functions of the managers as "political suppliers", as well as their bargaining positions in the struggle for resources; moreover, in general this contributed to their increasing political influence on state decisions.

[2] These problems, as noted above, had their origins in the paternalistic nature of the regime. These tensions are non-existent in a "market-based dictatorship", or in a Ceausescu-type strongly authoritarian "planned dictatorship". In the paternalistic regime the role of coercion became secondary, and the maintenance of social peace, which enjoyed high priority, *was essentially* based on material compensation.

[3] While the agencies of the party-state responsible for economic equilibrium fought, sometimes with success, for the curtailing of the discretionary rights of the direct agencies of control, and even for their abolition, the latter questioned the right of existence of the "technocratic" agencies of the state. After the introduction of the 1968 economic reforms, the local party organizations, hand-in-hand with the branch ministries and the managers of large public enterprises, successfully fought for the withdrawal of some of the major institutions of economic reform, and attained the political neutralization of the "fathers" of economic reforms. In the late 70s, on the other hand, the technocrats' positions again became stronger, leading to the complete abolition of the branch ministries in the industry; the latter were charged with "too close identification with the interests of public enterprises".

At the beginning of the transition, active managers of leading public enterprises became members of leading political bodies. Two public enterprise directors were coopted to the Politburo. At the same time the so-called "spontaneous privatization" began to take place, allowing managers to become the legal owners of public property.

The strengthening of the managers' powers of control over property was not only due to the enhanced political position(s) of the technocratic wing of the party-state: it was also due to the weak position of labour. On the way to the changes in property relations, the most crucial step was probably the introduction of the system of self-government of public enterprises in 1985. Similar institutions had been implemented a few years earlier in Poland and were later introduced in Bulgaria. In all three countries the new system promised to increase the economic control of labour. The institution was not introduced because of the enthusiasm concerning workers' property, but rather as an attempt to reduce the dependence of enterprises on the state bureaucracy. Although the three countries had similar reasons for their respective reforms, the power relations among managers, state bureaucrats and labour were formed in significantly different ways. This is why, in each country, different groups could realize their interests through the institution.

In Poland, the "Solidarity" trade union movement was involved in the creation of the law on self-governments and even after the banning of the union, the leaders of the Polish regime did not dare to modify the content of the law significantly. Due to this, Polish labour gained comparatively strong positions within the enterprises at the beginning of the economic transition.

In Bulgaria, both managers and labour had weak positions *vis-à-vis* party-state technocrats at the time of the introduction of the law. Thus, although the law strengthened labour positions within the enterprise in the time before the transition, their rights were withdrawn before they were able to become "too strong" and make workers competitors for property rights *vis-à-vis* the state.

Finally, in Hungary, the politically neutralized labour did not have any influence on the introduction of the institution and, at the time of the creation of the law, public enterprise managers held strong political positions. Thus, the Hungarian law on enterprise self-governments, instead of weakening the managers' positions *vis-à-vis* their labour, actually strengthened their position, by giving them the means to partly influence and partly control the selection of the members of the self-governments.[4] On the other hand, the new institution contributed to the further

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[4] Self governments were formed at two-thirds of the public firms. They were given the right to control almost all the strategic decisions of the firms, including the appointment of managers and the basic questions concerning property rights. One of the "fathers" of the new law reassured the managers of large public enterprises (fearful of the introduction of some kind of worker self-management) in the following way: "This is not a revolution, we are merely introducing an institution which already exists in several brotherly countries. If the managers there could cope with their employees, you will certainly learn quickly how to use these new mechanisms". The

strengthening of the mangers' bargaining positions *vis-à-vis* the state bureaucracy by increasing their controlling rights over property.

Summary: from perverse marketization to stalemate

The nature of the relationships between the key economic actors pushed the pre-transition regime through three stages, representing a vicious circle of neither reform, nor political stability.

The first stage, in the 70s, was the period of the "lazy monopolist" (*Hirschman* 1986). The rapid growth of the second economy, a kind of self-compensation and political self-demobilization of the working class, allowed for the delay of serious economic reforms in the public sector and for the stabilization of the political positions of public enterprise managers. In this period the scope of market relations increased only in the second economy, with the perverse effect of further contributing to the weakening of the potential political pressure for extension of the market in the public sector.

The second stage started in the late 70s, when the unchanged public economy, unable to compete in the rapidly changing world market, entered into a growing economic crisis. In that period a highly demobilized working class, busy in the second economy, was unable to influence economic policy-making. To re-establish the equilibrium of the economy, the party-state was ready to increase the scope of the market in the public sector but, due to the divisions inside the party-state mentioned above, and to the politically strong positions of managers, major reforms in the productive sphere were blocked by an alliance of state bureaucrats defending their discretionary rights, and managers of large public enterprises. The latter skilfully played on the fears of party leaders, who were worried about losing a great part of Hungary's hard currency earnings and the support of tens of thousands of workers who would be made redundant if subsidies were discontinued (Szalai 1989). Thus, the course of marketization took another perverse course. In that period, marketization, while leaving the sphere of production largely unchanged, meant the introduction of market principles in the redistributive sphere. This involved decomposition of a large part of the "socialist welfare state", the gradual and continuous reduction of price subsidies for consumption goods, cuts in welfare services and, in general, the withdrawal of the state from such areas as social housing.

new law, under the direct pressure of the managers of public enterprises, gave the employees only formal powers in the selection of the members of the new institution. The "enterprise councils" basically became means in the hands of managers, who had the right to select half of the members of the councils, to control the enterprises and, after the introduction of the company law in 1988, to start the process of "spontaneous privatization"—a euphemism used to describe the type of privatization controlled by the managers.

The third stage started in the mid-80s, when party leaders started to speak more and more often about the "limits of toleration of the society". As a result of the perverse marketization which started in the late 70s, workers experienced at the same time a continuous decline in the real value of their wages, and a faster and faster abolition of social welfare services by the state. All these had previously legitimated the artificially low level of their wages.

By the mid-80s the party-state had entered into a vicious circle of "fear of society—fear of reforms". The political elite feared the growing pressure requiring the placing of more burdens on the society. The last party congress presided over by János Kádár, the ailing communist leader of Hungary, decided to accelerate economic growth, and parallel with this, the consumption level of society. Because of the unchanged nature of the public sector, the new economic policy had disastrous economic consequences. Economic stabilization and reform were unavoidable, but the fear of the political consequences of reform led to its delay and the introduction of only half-hearted stabilization measures. The latter were not sufficient to stop the rapid deterioration of the economic situation. The fear of economic collapse grew rapidly and together with it, the fear of the political consequences of introducing reforms.

In this situation, there were in principle two separate ways in which the economic reforms needed to halt the economic disintegration could be introduced: the radical demobilization of the society, or the creation of a political base for the economic reforms by introducing political reforms.[5] In the new geopolitical situation of the second half of the 80s, the first option was not open to the highly divided Hungarian political elite (*Bruszt and Stark* 1991).

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[5] In Eastern Europe, deep in the middle of an economic crisis, there were, in principle, four options available for coping with the crisis. One was to *stick to the status quo*, thus not *making* any economic, or political reforms, and strengthening the authoritarian and repressive features of these East European communist regimes in order to prevent the translation of economic tensions into social and political tensions. This was the strategy of the communist leaders in Bulgaria, Romania, Czechoslovakia and the GDR. Another strategy was the *political opening without economic reforms*—the course of action chosen by Gorbachev.

For the leaders in Poland and Hungary, the two most indebted countries of the region (with political leaders more and more haunted by the memories of, respectively, 1981 and 1956, the years of the two biggest uprisings in the region) not implementing economic reforms would have been suicidal. They were in a situation in which they could count on neither Moscow's economic help to get out of the economic crisis, nor on its military help in the case of an uprising. While fearful of the potential consequences of not implementing reforms, the leaders of these countries feared also the social, and thus political consequences of radical economic reforms. In both countries there were proponents of the introduction of some kind of "*market-dictatorship*", combining political demobilization of the society with radical economic reforms. After some fearful experiences, this strategy was dropped in both countries, basically due to the lack of political basis for these strategies even within the regime. While in Poland the political opening was directly related to the desire to start encompassing economic reforms, in Hungary the relationship between economic reform and political change was somewhat less direct (See: Bruszt and Stark 1991).

Some analysts of state-socialism used the term "state-corporatism" to describe this type of political regime. The term "state-corporatism", as applied to this regime is, however, misleading. One of the most important features of corporatist techniques, and in general, of the corporatist regimes, is their capacity to give priority to considerations related to system-maintenance. This happens either through the more or less voluntary cooperation of functional interest groups orchestrated by the state, which is usually called liberal corporatism, or through the forced imposition of the will of the state; the latter is usually called "state-corporatism" (*Lehmbruch and Schmitter* 1969; *Cawson* 1986). The Hungarian regime of the 80s could at best be called a "perverse" variant of corporatism, in which special interests enjoyed priority over the considerations of system maintenance.[6] The party-state of the 80s was more similar to an oligarchy, in which the leaders of state enterprises held stronger and stronger economic controlling and political-bargaining positions against the leaders of the party-state. The latter were frightened and paralyzed both by their fear of economic collapse and their fear of society.

Market reforms in the new regime

The promise of a virtuous circle

The coalitional government led by the Hungarian Democratic Forum (HDF), having a stable majority in the parliament, took up a peculiar mixture of transition politics, which was similar to the others in the region in its etatism, but was different from them in its gradualness (Bruszt 1992). The major features of their strategy were the following:

— The insulation of any economic decision-making from the parliamentary opposition, the trade unions and the business organizations

— The re-centralization of economic decision-making, including the "re-nationalization" of public enterprises

— Gradualism in the introduction of economic reforms

— Continuous attempt to demobilize society in general, and trade unions in particular.

From the viewpoint of the relationship of the major economic actors, the goal of the new government was to rapidly strengthen the role of the state bureaucracy (which would be protected from outside political pressure) in tandem with the drastic weakening of both labour and enterprise management.

The transition strategy, based on the four pillars described above, promised to transform the vicious circle entered into by the late Kádár regime into a virtuous circle:

[6] See a similar argument about the Polish regime in Jerzy *Hausner* (1992).

— a stable government, enjoying a majority in the freely elected parliament, and insulated from particularist interests, would work out a coherent programme of economic transition

— the programme was to be introduced gradually, so as not to alienate too many interest groups too fast;

— to prevent potential resistance to the implementation of the reforms, trade unions would be neutralized in advance;

— to control the process of economic reform, and most importantly, to take away from the managers control over the process of privatization; economic decision-making was to be recentralized and public property was to be "re-nationalized";

— the gradual and controlled changes, after a short period in which there would be an increase of social burdens and recession in the economy, would lead to an improvement in economic conditions;

— finally, the slowly improving economic conditions would contribute to the (re)creation of the political basis of the government;

Continuity and change

The Antall government began its activity by creating the constitutional conditions for keeping economic decision-making away from the parliamentary opposition. The political pact made between the HDF and the biggest opposition party following the free elections resulted in a constitutional constellation which allowed the governing coalition, possessing a stable majority in the parliament, to consider the politics of economic transition as its own private affair for the four-year-long governing period. Furthermore, the constitutional re-design of the position of the Prime Minister along lines similar to the model of the German Chancellor, allowed for a strong centralization inside the government.

In the realm of industrial relations, the first step of the new government was to politically neutralize the trade unions. In practice this meant preventing the otherwise weak and divided unions from getting stronger. The new Ministry of Labour began to undertake its unique mission against labour with great enthusiasm. One of its first steps was to have the old enterprise self-governments, which were in favour of the managers, re-elected by using the old electoral process. The latter had been co-designed under the old regime by the representatives of managers. Later, in the process of the renationalization of public enterprises, even these bodies were abolished in the process of the "corporatization" of public enterprises. This meant the obligatory transformation of public enterprises into company form, governed by a board of directors. With the abolition of the enterprise councils, the government prevented Hungarian labour from becoming competitive partners with the state in the competition over property. The labour and economic legislation following this act resulted in a series of additional acts which provided labour with merely

the "right to grumble" in such cases as the transformation of the enterprise form, change of ownership, the division or fusion of the enterprise, or bankruptcy.

The legalized exclusion of labour from the process of economic transformation was completed by the political weakening of unions and their division; this process was also directed from the top. The policy of the government towards trade unions, together with the sociological obstacles in the way of union-organizing mentioned above and union leaders' short-term policy-making strategies, resulted in the political neutralization of trade unions at the macro level.

At the level of public enterprises, labour was marginalized, not only because of the new legal regulations, but also because of the disappearance of those economic factors mentioned previously. The latter had been the basis of their bargaining position within the enterprise.

The third condition of the etatist market reform was the discontinuation of the political role played by public enterprises. This was brought about partly through the radical weakening of managers' economic and political bargaining positions, partly through the strong centralization of economic decision-making, and partly through the transformation of property relations. When the first signs of the political neutralization of labour appeared, the government energetically attempted to reclaim the state's rights to property, to extend state control over the process of privatization, and to recreate state control over the economy in general.

As one of its first steps, the Antall government put the process of privatization under the control of the State Property Agency (SPA), giving it the right to take under direct control any public enterprise.[7] Later, the government created another gigantic controlling agency, the State Property Company (SPC), with the task of supervising and controlling those public enterprises which were to remain in state ownership. Free from the influence and direction of the parliament, these two agencies gained control of the entire public sector.

The extended recentralization and renationalization of the public economy could have allow for a controlled process of rapid privatization, and a balanced process of economic reform. However, in practice, privatization was slow and, except for the short-term stabilization programme (which resulted in recession), no reforms were introduced to increase the growth-capacity of the economy. Moreover, the government delayed the introduction of several reforms, such as the state household reform, which would have reduced the rapidly growing internal indebtedness.

Significant changes were achieved by the Antall government only in the field of short-term economic stabilization. This was partly a result of the fear of growing economic imbalances, and partly a result of pressure by the IMF and other creditors. Thus the government radically reduced the direct budgetary subsidies that

[7] The SPA *received* the right to renationalize any public enterprise *if it was deemed to serve* the "protection and sale of state assets". "The criteria of decision-making were loose enough to justify the renationalization of any organization." (*Voszka* 1993).

were being given to public enterprises, maintained a strict monetarist policy, and rapidly increased the liberalization of foreign trade. This resulted in, among other things, a growing import-competition. These and other measures, together with the collapse of the traditional Eastern markets, contributed to the rapid weakening of the economic positions of public enterprises.

Having neutralized its potential competitors—i.e. the workers and managers of public enterprises—and having isolated the economic branches of the state bureaucracy from potential parliamentary influence, in principle, the governing coalition could have started to implement a coherent economic reform programme. However, instead of genuine privatization and reform, recentralization of state control was used more and more for the repolitization of the economy—i.e. the shrinking public sector was used for short-term political purposes (Szalai 1991; Voszka 1993; *Petschnig* 1993). Examples include the distribution of public assets in order to strengthen the cohesion of the parties forming the governing coalition,[8] the distribution of public assets and controlling positions over public enterprises in order to create patron-client relations within the economy, the helping out of loss-making public enterprises using commercial banks under state control, the delaying of the implementation of previously announced economic reforms with the aim of halting the erosion of electoral support for the governing parties, and the creation of special funds to strengthen the financial foundations and the electoral strengths of the leading party in the coalition.

As a result of the repolitization of the public economy, relations between the state bureaucracy and managers again became a function of a mixture of economic and non-economic expectations. Sometimes political considerations were given the main emphasis, while at other times economic considerations were stressed; this was conditioned by which fear happened to greatest with the politicians: fear of society, electoral defeat, or economic destabilization.

These practices differed from those of the Kádár regime, both in their scope of application, and in the means of exchange in the re-established paternalistic and patron-client relations. The recession, together with the fiscal crisis of the state, did not make it possible to abolish measures aiming at stabilization, and did not allow for the excessive use of free state money in the form of subsidies or tax-exemptions. Instead, the state-bureaucracy was able to use such favours as assisting in the renegotiation of debts, maintaining monopolistic positions, restricting entry into a given market segment or reducing competition through exemption from import competition.[9] These types op favours delayed the appearance of the harmful conse-

[8] The regulations of the restitution of the peasants and of the church, with highly dubious economic consequences, were the major preferences of the two smaller parties in the governing coalition.

[9] Éva Voszka calls attention to the ways a government can use its increased control over the public economy to help public enterprises without immediately increasing the budget deficit. "Most of these methods imply the centrally controlled reallocation of income and enterprise positions.

quences of the political use of public enterprises, and pushed the burdens resulting from them further into the future.

These practices, however, were similar to those of the Kádár regime in that they were not restricted or controlled by a coherent reform programme, and only a detailed case by case analysis could separate the role played by short-term political considerations and/or macro-economic consideration in the thousands of state interventions into the economy.

From among the several factors which have contributed to the re-emergence of the old trap of the political use of public economy, the following three are worth mentioning:

The first is the phenomenon known as the "orthodox paradox" in the literature of the political economy of reforms: "the attempt to use the agencies and personnel of the state to diminish or dismantle their own power" (*Nelson* 1989). The state bureaucrats and party politicians, not controlled by the parliament, would have had to have been saints—which they were not—to resist the temptation to retain "some" discretion over the allocation of resources in order to manipulate support for the coalition. The coalition government would have had to act as a kind of modern Ulysses—which it was not—and bind itself to the mast in order to make current intervention motivated by short-term political considerations difficult or impossible. Lacking any serious "economic separation of power", both the temptation, and the possibility of giving in to the temptation was high (*Elster, Offe and Preuss* 1991).

Another factor contributing to the dependence on the political use of the public sector was the unexpectedly rapid erosion of the political basis of the coalition government. Only a few months after its inauguration, the government suffered a humiliating defeat at the local elections. Moreover, according to the surveys of public opinion, trust in the government and in the parties of the governing coalition, as well as in the leaders of these parties, was in continuous decline.[10] The three parties in the coalition, which controlled more than 60 percent of the seats in the parliament having gained 45 percent of the votes at the election, together could count on at most 30 percent of the votes according to surveys done throughout 1991, 1992 and 1993. Another sign of rapid erosion of support for the government was illustrated by the single major act of resistance against the economic measures of the government; this did not come from where it was expected—i.e. the trade

Redistribution could be applied despite the high and growing budget deficit, because these new forms avoid direct expenditure. The greater part of the costs are covered by other enterprises or commercial banks that carry out state instructions or get a financial or some other reward." (Voszka 1993, p. 10).

[10] The "hit-list" of party politicians, consisting of the ten most popular political leaders, was in this period continuously occupied by opposition party leaders, and according to the various indicators of support for political leaders, none of the bosses of the governing parties even had a chance of becoming part of this "list".

unions—but from the taxi-drivers. The latter protested against the increase of the price of petrol by putting up a three-day blockade on major roads, and forcing the government to abolish the additional tax on gas.

The government's growing political uncertainty, which was further aggravated by its growing fear of losing the next election, played a central role in the re-activation of the practice of using the public economy for short-term political purposes. Soon after the political neutralization of its potential competitors, the government started to display growing signs of insecurity and fear of society. The stronger this fear became, the more the signs of internal fractionalization and fragmentation of the governing coalition multiplied. While in regional comparison society's resistance against reforms, and thus actual pressure from below, was low, there was growing pressure on the government from within the governing coalition to manipulate public economy in order to generate popular support for the parties in the coalition, or to at least halt its decline.[11]

Finally, a third factor which contributed to the reactivation of old practices was the unexpected increase in potential negative consequences for society. Thus the political stakes of reforms were raised. This was due to the much deeper than expected economic recession which resulted in, among other things, nearly 15 percent unemployment, a continuous decline in the real value of wages, and the growing indebtedness of the social security system. The lack of any serious external help, combined with the economic consequences of the significantly slow change in the economy further increased the pressure to postpone necessary reforms.[12]

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[11] For example, the extreme right in the governing coalition, which came dangerously close to capturing the government from within, proposed the establishment of an anti-reform coalition based on the losers of the economic changes, against the "liberals" and other "agents" of the IMF, Washington and Tel Aviv. While the representatives of this group were in the end marginalized and excluded from the biggest governing party, the attempts of those who stood for the use of privatization for short-term manipulation of support coalitions were more successful. The minister of privatization *had*, for a while, even served as the electoral campaign manager of the biggest party. On the other hand, as a result of the internal fragmentation and the desertation of party members, by the end of 1993 the governing coalition *came dangerously close to* losing its majority in the parliament.

[12] The desire to maintain, or at least slow down the erosion of political support led the government to enter into a vicious circle of postponing state-household reforms: in other words, in a situation in which the revenues of the state declined rapidly, the government, fearing the social and political consequences of further cuts in social services, postponed the reform of the state-household system. This contributed to the growing budget deficit and the pressure to maintain excessive taxation. The growing budget deficit and excessive taxes further contributed to the decline in state revenues by exacerbating the recession, by forcing economic actors "to go informal", and/or to evade taxation (*Greskovits* 1993). The further decline in the revenues helped to increase the potential social costs and thus the political stakes of state-household reform. Thus cuts in spending and reform of the state-household system were postponed again...

Gradualism and demobilization—conclusions

The reform policies of the late-Kádár regime and of the first democratic government were similar, in that both of them used political tactics aiming at the demobilization of society, and tried to manipulate supporting alliances in the economy.[13] However, the political and economic conditions of economic reforms were different during the two reform attempts. While the Kádár regime could not use democratic political tactics to manipulate supportive alliances in the realm of politics, the Antall government chose consciously to abuse the opportunities offered by majoritarian democracy in order to create the political conditions of its reform strategy of excluding all other actors. The Kádár regime could continue its practices in the economy until it had depleted both the economic resources and the political capital it had acquired during its "golden era" in the 70s. The economic conditions inherited by the Antall government did not allow for the same level of misuse of public economy for short-term political goals as was the practice under the Kádár regime. Vacillating between fear of the IMF and fear of punishment at the next elections, the Antall government did not give up its stabilization policies, and instead used tactics which delayed the appearance of the harmful consequences of the political use of public economy by pushing the inevitable concomitant burdens further into the future.

Despite these differences, one can observe the same logic at work in both of these two attempts at economic reform. The essence of this logic can be summarized in the following way: uncertainty breads uncertainty. The growth of economic and social uncertainties among the different social groups, as a result of the rapid growth of social burdens in the framework of exclusionary policies, undermined the political bases of these governments, decreased trust in political organizations and politicians, and increased disbelief in the competencies of the respective governments. In the Kádár era the rapid erosion of the political basis of the party-state led to the growing uncertainty of the political elite resulting, eventually, in the disintegration of the state-bureaucracy and the stultification of state power. Under the Antall government, the erosion of political support led to the growing uncertainty within the new governing elite, resulting in growing fractionalization and fragmentation of the governing coalition.

[13] In comparison to its alternatives, this is perhaps the worst possible strategy. Reformers, in principle, could choose the strategy to try to manipulate supporting alliances primarily in the realm of politics, and undertake determined reform policies in the economy. Or alternatively, they could disregard the possibilities offered by democratic politics and undertake a jump into the unknown, by *experimenting* with shock-therapy. While the potential political costs of such undertakings can be extremely high, the strategy of gradualism combined with demobilization, with its combined political and economic expenses, is a competitor for the distinction of the worst possible strategy!

In the end, both the last communist government, and the first democratic government turned to more inclusionary policies in the realm of politics in order to halt the erosion of their political base. In the case of the last communist government, the opening played an important role in the political regime change. Nearing the end of its term, the Antall government started to negotiate with trade unions and business associations. These negotiations, however restricted in their scope and achievements, signalled a departure from the previous strategy based on gradualism and political demobilization.

Finally, the economic and political costs of the use of the economy to manipulate alliances and the use of politics to demobilize people, were extremely high, and the change in strategies came too late. In the case of the Kádár regime, this strategy resulted, among others things, in the doubling of the economic indebtedness of the country. In the case of the Antall government, the economic costs of this strategy have, to a large extent, been invisible—they will be paid for by the governments of the future.

The political consequences of the Antall government's strategy of gradualism combined with demobilization are more visible. The strategy of reform chosen by the first democratic government largely contributed to the growth of political alienation in the society, considerably weakened those potential partners who were ready to enter into socio-economic pacts, and increased the room for manoeuvre of populist anti-reform alliances. The exclusionary strategy of the governing coalition largely contributed to the growth of uncertainty in society, and the shortening the time horizon of people. This has led to the rapid increase of support for forces which are perceived, rightly or wrongly, as representing paternalist policies.[14]

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[14] In the 1993 elections for the self-governments of the social security funds, which were competitive elections between the seven trade union confederations, an absolute majority was won by the post-communist trade union confederation. According to political analysts, people voted in these elections not for the trade unions, which they distrusted, but against the policies of the government. Whatever their motivations, people gave control of the social security funds, rivalling in their size the state budget, to the "old/new" trade union bureaucracy. Similarly, the popularity of the Socialist Party, the offspring of the former communist party, was in continuous ascendance, and this resulted in a remarkable landslide victory for them in the 1994 general election.

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SMALL ENTREPRENEURSHIP IN HUNGARY—AILING OR PROSPERING?

Historical and Contextual Dependencies in Comparative Perspective*

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As a result of an almost explosion-like expansion of self-employment, in the branches other than agriculture already more than one fifth of employment is self-employment in Hungary, an outstandingly high ratio by international comparison. As against professional public opinion which rejoices at this fact, it may well be that we are witnessing an over-population and over-fragmentation process in enterprise which may endanger the success of economic transformation.

What sets us against one another is not our aims—they all come to the same thing—but our methods.

Antoine de Saint-Exupéry

In the mid-1970s, when I started to study Hungarian small-scale private economy as it existed at that time (or the second economy, as I called it), I regarded this peculiar private economy, in contrast to the prevailing view, as an organic part of the state socialist order. I did not view as a mere vestige of the capitalist past or as some sort of anomalous outgrowth of socialism. My main concern was to clarify the inherently conflictual nature of the relationship that existed between the second economy and the first, and to form an idea of the probable long-term outcome of that conflictual, partly competitive, partly complementary relationship.

Up until the early 1980s my views on this long-term outcome were based on the anticipation of successful reforms within the first economy which would have the effect that market mechanisms would soon become the dominant mode of co-ordination in that sector. This would have made the boundary between the two sub-economies less and less marked. Then, however, the apparent failure of the reformists to place the first economy on a market footing without altering the predominance of state ownership led me, by the mid-1980, to expect future evolution of the system to occur, through the expansion of the second economy

*This paper is based on the author's Fellow Lecture delivered at Collegium Budapest on April 28, 1994.

rather than from further reforms within the state sector. From that time, it was through the expansion of the second economy that I expected the attributes of a market economy to gain prominence.

A few years later, towards the end of the 1980s, when the transformation into a capitalist market economy became the order of the day, I had of course to reconsider again my view on the potential evolutionary role of the second economy. As a result, I came into conflict with the general view which, at that time, being on the eve of a radical systemic change, regarded small businesses evolving from the second economy as a vehicle or a catalyst for transition to a market economy.

True, I myself was expecting a rapid spread of small businesses. Nevertheless, I thought it unlikely that the mass of semi-wage workers—semi-entrepreneurs, who had been socialised under conditions of state socialism, would now quickly and eagerly adjust their economic mentality to the requirements of a market economy. I feared that, instead, the inherited mentality would impress itself for a long time to come upon the course of development of small entrepreneurial activity.

The body of experience gained during the first two years of transformation has reaffirmed and increased my fears. I came to realise that the course of development of small businesses has been adversely influenced, not only by the historical heritage, but also by the context of the transformational crisis itself. In particular, in mass and chronic unemployment I can see a contextual factor which has acted against the emergence of an efficient and dynamic small business sector.

Two more years have passed since that assessment. Now, after four years of attempts at systemic transformation, it is again time to evaluate the current standing and future prospects of small entrepreneurship in Hungary.

In evaluating the developmental trends of small entrepreneurship in contemporary Hungary, I have in mind primarily the so-called "individual small business undertakings", whose working owners constitute the largest segment of the self-employed category in numerical terms. In identifying this segment, I will of course make allowances, as required by international comparability, for the fact that unpaid family helpers, members of production co-operatives and working owners of what in Hungarian phraseology are called "joint undertakings without legal entity" are also treated in international statistics as self-employed.

Adopting a macro-level economic approach to assess whether small entrepreneurship in Hungary is ailing or prospering, I will concentrate on the effects of narrow economic determinants as observed in larger aggregates of self-employment. Starting from the experience of established market economies as a comparative standard of measure, I will argue that small entrepreneurship in Hungary is exhibiting a syndrome which might be characterised as "too many–too little". In conclusion, I will suggest some of the economic policy implications of this syndrome.

Small-entrepreneurship in contemporary market economies

Three sets of research findings concerning small entrepreneurship in market economies are especially relevant for establishing an objective comparative measure, namely (1) secular trends and cross-country variations, (2) short-term cyclical fluctuations and (3) intra-country spatial variations in the size of self-employment. Let us discuss each of these in turn.

(1) Let us first consider secular trends and cross-country variations.

A century-long data series gathered for today's advanced market economies testify to a steadily declining trend of self-employment up until the 1970s. This trend cannot simply be interpreted as a by-product of the falling share of employment in agriculture (given its traditionally high rate of self-employment), for the same declining trend can be observed within non-agricultural employment. Therefore it must be rooted in developmental tendencies more or less common to all sectors, most probably in a steady increase in economies of scale.

We might speculate whether the unexpected reversal of this declining trend in the 1970s can be attributed to particular developments in the world economy, such as the rise of energy prices and the resulting stagflation. On the other hand, it could have been due to country specific government policies, such as the granting of greater benefits to the self-employed as a way of countering unemployment on the Continent. It might have been caused by the rising of marginal tax rates on higher incomes in the United States. More fundamentally, we may question whether this was an episodic deviation from the earlier historical trend or, as is claimed by many, the emergence of a new course of development.

This latter possibility is supported by strong arguments. Some point to the revolutionary penetration of computers into industrial production, leading to radical cuts in economies of scale. Others focus upon the growing instability of the world market of our time, which they claim undermines the viability of traditional mass production given its specialised manufacturing equipment. Yet, however promising these arguments may be, the recent expansion of self-employment is both still too short and too modest to warrant the conclusion that it marks an epoch-making change in the earlier declining trends.

If time series study indicates, at least up until the 1970s, an unambiguously negative impact of economic development on the rate of self-employment, cross-country comparisons yield less unambiguous results. While the negative effect of economic development on self-employment seems evident when considering group averages of countries sharing similar levels of economic development, too many individual countries diverge for economic development to stand as a sufficient explanatory factor.

In order to identify additional factors that might contribute to cross-country variations in self-employment, I conducted, by way of experiment, multi-variable linear regressions. Self-employment rates among OECD countries were taken as

a dependent variable, and the independent variables were the level of economic development (as measured by per capita income), the rate of unemployment, and an index of labour market corporativity. The choice of economic development and unemployment as independent variables is self-evident. The inclusion of labour market corporativity (i.e. the role of macro-level negotiations between organisations representative of collective interests) as the third independent variable was motivated by the conjecture that corporativity, to the extent that it modifies employment conditions, may also influence the choice of self-employment. In addition, corporativity of the labour market may be construed as a proxy for economic actors' disposition for action (association, co-operation, etc.), and if for this reason alone it can be seen as more or less characteristic of the entire economic system, including the small business sector.

Contrary to a common sense expectation that higher or increasing unemployment rates generate higher rates of self-employment, our preliminary analysis suggests no such positive correlation. One should not conclude from this statistical finding, however, that self-employment bears no relation to the rate of unemployment. The counter-intuitive coincidence of a relatively high rate of self-employment and a relatively low rate of unemployment in a particular country at a particular time might also indicate that, for instance, an earlier rise in the rate of self-employment has lowered the unemployment rate.

Beside this negative lesson, the cross-country regression analysis also yielded a positive result. The level of economic development and corporativity combine to account, with a high degree of significance despite the small number of countries included in the analysis, for about one half of the cross-country variation of self-employment rates in both the industrial and service sector.

Here, the "outlying" cases are also instructive. For example, Italy and Japan both have strikingly high non-agricultural self-employment rates compared to the predicted values of the regression equations, and exemplify, though in radically different ways, the close integration of small businesses. Italy is known, particularly after the industrial districts in the North, as a classical case of the horizontal integration of small businesses. In this structure micro-enterprises are linked typically on a basis of flexible specialisation. Japan typifies the close vertical, or pyramidal, integration of small businesses into large enterprises. Generalising from these two "outlying" cases, one may venture the proposition that the economic role of self-employment depends in no small measure on the degree of economic integration of small businesses—i.e. on the existence of a kind of support network which nevertheless does not deprive the self-employed of their independence. This hypotheses could be supported by the counter-example of those Latin-American countries who are struggling hard to escape their state of underdevelopment. Characterised by a peripheral position in the world economy, a dual economic structure with a proliferating informal economy and high rates of urban unemployment, these countries also exhibit extensive self-employment. However, with the virtual absence of

the integration of small businesses and the high rates of self-employment in these countries—in contrast to the Japanese and Italian cases just discussed—they have over-populated and stagnating small-business sector.

Before proceeding to the discussion of short-term fluctuations, let me close this section on the long-term trends and cross-country variations of self-employment rates by advancing two more hypotheses on the importance of the degree of economic integration of small businesses for the rate of self-employment.

According to the first hypothesis, the integration of small businesses, horizontal and vertical alike, would increase self-employment partly by widening the domain of economic activities in which small businesses can meet the requirements of economies of scale; this may account in part for the strikingly high rates of self-employment in Italy and Japan. Yet the horizontal integration of small businesses may simultaneously reduce the number of other economic organisations, for horizontally integrated small businesses are capable of replacing economic organisations with a large workforce. On the other hand, vertical integration may tend to reduce, not the number but the staff size of other economic organisations, for vertically integrated small businesses are capable of replacing production and employment inside the factory gates of large integrating firms. An empirical verification of these propositions could be seen as a confirmation of our hypothesis.

According to the other hypothesis, complementary *to* rather than exclusive *of* the former, the positive effect of the degree of integration of small businesses on the rate of self-employment is brought about *via* the effect that it creates by slackening the dependence of the self-employed on household needs in their business behaviour. A slackening of such dependence fosters longer-term business rationality against the short-term consumption orientation of households, and thereby it works towards greater economic efficiency. Once again, this hypothesis might help to explain the positive relationship between the degree of integration of small businesses and the rate of self-employment. This appears in the examples of Italy and Japan. At the same time, it might bring light to bear on a possible root cause of the low economic efficiency of self employment in Latin America.

(2) Let us now embark on the discussion of short-term fluctuations of self-employment, as observed in the succession of business cycles.

Any relevant econometric study would start from the assumption that individuals switch from waged-employment to self-employment (and *vice versa*) as a response to shifts in the expected relative returns on self-employment versus waged-employment. Inflow into self-employment will thus fluctuate—according to the "push" hypothesis—counter-cyclically. In other words, it will be parallel to unemployment, since rising unemployment will lower the expected return to waged-employment. Considering the "pull" hypothesis, however, with the profitability of self-employment moving as it does parallel to the business cycle, short-term fluctuations of new entries into self-employment may well exhibit a pro-cyclical pattern.

Whether the resultant of such push and pull forces has a positive or a negative sign is *a priori* impossible to determine.

Business fluctuations may also have a contradictory effect on the gross inflow into self-employment *via* variations in the constraints on this inflow. At times of recession it becomes easier to achieve an independent status to the extent that more frequent setbacks in production and plant closings increase the supply of second-hand machinery and business premises that are out of use. This may encourage a higher rate of inflow into self-employment. At the same time, however, greater uncertainties in recessionary periods tend to stir more concern in banks and investors about provision of finance for new business start-ups.

The direction of the net effect of business fluctuations on outflows from self-employment is similarly uncertain. Boom periods exert a pull effect on the influx into the labour market, thus inducing outflow from self-employment. Yet, at the same time, it restrains outflows owing to the greater profitability of self-employment under such circumstances.

It is therefore not surprising that econometric studies which try to relate short-term fluctuations of self-employment—reflecting the net result of changes in inflows and outflows to cyclical effects—utterly fail to reach clear conclusions. Besides, a cross-country comparability of their findings would make a case for a rate-type self-employment indicator. The latter is a variable that would require explaining, such as the ratio of the self-employed to total employment, or to the labour force. Such a rate-type indicator, however, may vary through time, with employment decreasing at times of stagnation and increasing at times of revival in the denominator (without any change in the number of the self-employed in the nominator).

(3) In closing the first part, let us finally turn to the third set of research findings concerning small entrepreneurship in market economies: namely, regional dispersion of self-employment.

Unlike the cross-country comparisons and time series analyses that are reviewed above, (and which usually reveal no close and clear relationship between unemployment and self-employment), such a relationship is markedly and strongly negative in cross-regional comparisons within countries. Self-employment has a relatively low rate (characteristically in regions coping with depression), and a high rate in prospering regions. In other words, rather than serving to decrease unemployment in regions afflicted by depression, self-employment is itself victim to local depression. This is a tendency which not even government incentives for the unemployed to become self-employed are able to counteract; presumably this is because such benefits can be used to best advantage by the jobless in regions least affected by depression. For that matter, the positive effect expected of the various government measures encouraging self-employment cannot be verified at the macro-level, and this is probably because the undertakings thus established are either ephemeral or, if they become steady, displace already existing small undertakings.

Encountering the syndrome of "too many–too little"

I proceed now to the second part of my lecture, in which I will focus attention on the Hungarian experience.

As is well known, over the past four years we have witnessed a rapid, almost abrupt, proliferation of small businesses in this country. The number of registered non-agricultural individual small entrepreneurs rose from little more than 400,000 to over 700,000. In fact, today self-employment accounts for more than one-fifth of employment in the non-agricultural sectors. This is a high ratio by international standards, being roughly twice the average of OECD countries (11 percent). It exceeds by far the average of North Africa and the Middle East (15 percent), and is only slightly lower than the average for Latin America (26 percent) or the Asian region (27 percent). In five groups of countries selected by per capita income Hungary ranks between the figure of 25 and 18 percent for the second last and the middle group, with per capita income of USD 500 to USD 2,000, and USD 2,000 to USD 6,000 respectively. This ratio drops down to 13 percent in the group of countries ranging from USD 6,000 to USD 12,000, and is as low as 6 percent for countries whose income exceeds USD 12,000 per capita.

Considering also the large dispersion of self-employment rates across countries in the same group (i.e. of roughly similar levels of economic development, due to causes which have already been suggested), we are nevertheless not alone with this high self-employment rate related to our level of development. In contrast, leaving aside the former socialist countries of the region, the rapidity of such a spread of self-employment is indeed without parallel. Under conditions of economic decline and rising unemployment, not even a modest rate of expansion of self-employment is a general rule in the more advanced part of the world, as was indicated in the previous section of this study.

A special characteristic of increased self-employment in Hungary is the fact that it hardly helped to hold back the half million growth in unemployment and the more than 1 million decrease in employment. Unlike the number of individual ventures which increased by 300,000, the number of those employed by them increased within four years by less than 100,000. This paradoxical situation is due to the fact that the number of full-time individual ventures decreased relatively and the number of those pursuing a venture as a main occupation was small, and up until the end of 1983 it was decreasing. Even last year two-thirds of the large 80 thousand increase of individual ventures were recruited from part-timers and pensioners. Although in the first four months of this year the relative frequency of larger ventures—employing at least 9 employees or family members—increased in all the three relevant categories (two to two and a half-fold). Even so, only one in 500 ventures belong to these categories. This overproduction of ventures in recent years was seconded by a characteristic "overtertialisation" of individual ventures: entrepreneurs did not turn to production which required more investment.

At the same time not only in the sphere of individual but also in the sphere of collective ventures only the smaller ones (up to 10 people) multiplied. From the 30,000 growth in their number between the end of January last year and the end of April this year, only 800 employed more than 10 people and only 250 more than 20. Furthermore, a spectacular increase in ventures was only experienced among organisations with legal entity belonging to the smallest categories. In the next category, the growth of those employing 11–20 was meagre last year, and even this growth arose from the splitting-up of former large partnerships. It was not due to the foundation of new ventures or the incorporation of old ones. This year even last year's small increase was not only halted but also reversed. Besides that, a large part of foreign property in the form of new partnerships belongs to this size category. This is indicated by the fact that with two-thirds of the several thousand foreign property organisations the base capital was no more than the legal minimum: i.e. HUF 1 million.

Taking all these facts together, it is highly unlikely that transformation either into joint undertakings without legal entity, or into limited liability companies, today represents a significant channel for increasing the size of individual undertakings. Indeed, we may even suppose that the excessive spread and overfragmentation of undertakings are peculiar not only to individual undertakings, but also to joint undertakings and even to firms with legal personality.

However, it has to be asked whether it is not possible that the above overpropagation and oversplitting, which rely on official statistics, are a mere statistical "artifact"? It is well-known that in today's Hungary a certain proportion of registered individual entrepreneurs do not pursue any business activity—they exist only on paper. Another section of individual entrepreneurs are marginalised employee. At the same time with many ventures business activity is far more important than suggested by the assessments of the statistics.

First: if we can demonstrate that an important—possibly increasing—part of those assessed by statistics as self-employed are hidden employees or phantom entrepreneurs, it does not follow that the actual number of small ventures is less than the same number. In my opinion it would be a sign of overpropagation and oversplitting if it turned out that the small venture sector was in fact "diluted" compared to its ideal type.

Second: if we could demonstrate that a large section of the self-employed have a business activity which surpasses the registered level, and is actually increasing the gap between statistics and reality, it does not follow that the units of the small venture sector are that much stronger. The gap would signal the weak propensity of ventures to grow, assuming that with a given venture size the expected increase is in reverse relation to the extent of the concealment. This is because, with more concealment, it is harder and more expensive to acquire the outside financing necessary for further expansion.

There is little question that these adverse characteristics of small business development in Hungary are related in part to the inertia of the economic mentality inherited from the second economy of the state socialist regime. The factors likely to have worked in this direction include the one-sided consumption orientation of households and their strong feeling against longer-term business investment and risk-taking, the accustomed leisurely pace of work in full-time employment, the low appreciation of free time compared to income, or the poor tax morale. At the same time their negative influence has been accentuated by the transformational crisis itself. This primarily refers to the pressure for short-term adjustment of households to rising unemployment and falling real wages. Yet I do not think that all these factors should necessarily have been instrumental in the excessive numerical growth and overfragmentation of undertakings.

Obviously contributing to this process of proliferation and fragmentation has been, first of all, the exaggerated and one-sided propaganda campaign advertising entrepreneurship as a wide and preferable alternative path to success in life. It has disregarded international experience concerning the "normal" economic weight of self-employment because it has tried to create an inferiority complex in people shy of establishing a business. This overtly aggressive propaganda has served, willingly or unwillingly, the spontaneous mechanism by which more and more people embarked on a business solely on the grounds that, for lack of direct experience to guide them in the new situation, they judged business prospects according to the proliferation of undertakings. The internationally very high ratio of prospective entrepreneurs, reaching its peak of over 40 percent in 1990 in public opinion polls, is indicative in this respect.

Secondly, the rapid erosion of business contacts previously established between the second economy and large enterprises may have been another contributory factor to this process. Responding to the pressure of their economic difficulties, large enterprises cut their ties to small business partners first. Although it was possible to foresee the occurrence of this process and its unfavourable effect on small business development, the government did not even try, in the course of its passionate propaganda drive for the foundation of undertakings, to intervene by stimulating the integrative efforts of large enterprises, nor did it facilitate local-sectoral co-operative schemes between small entrepreneurs.

Finally, the growing weight of other than full-time employment and its preponderance in individual undertakings has directed attention to the extreme rigidity of the Hungarian labour market, to which official circles have adopted a virtually passive attitude of resignation. Under conditions of a market economy, it is not usually full-time business undertakings or second jobs that mainly fall victim to a slump. In fact, employment may even grow with the rise in unemployment, provided that the population of working age expands for demographic reasons. In contrast, the falling demand for labour in Hungary, which has been a consequence of the crisis, has caused a dramatic decline in employment without substantially diminishing

job security and curtailing the bargaining power at the workplace (i.e. the insider power) of those whose jobs did not fall victim of closures. They lost opportunities for extra work at their places of employment. It was mainly they who constituted the primary source of recruitment for the growing mass of entrepreneurs, and it was mainly the growing mass of people displaced from the labour market who, with little chance of getting rehired at a later time, swelled the ranks of working owners of overfragmented undertakings and their employees working under irregular and substandard conditions of employment. Thus there is little surprise that those who respond in the affirmative to the question of whether or not unemployment helps to improve work discipline in Hungary are in a minority in public opinion polls.

The unfavourable effects of inherited mentalities and of the circumstances of the transformational crises may have been coupled, moreover, with self-generating processes within the small business sector. In the first place, parallel with the proliferation and shrinkage of undertakings, economic inefficiency has become a less and less effective handicap to entry. In the second place, as the undertakings have grown in number and become smaller in size, it has become easier for them to conceal incomes. This has provided them with a means of protection—independent of economic efficiency—from larger organisations as competitors (which are less able to conceal incomes). In the third place, the more fragmented they have become, the less they can afford because of their diminished incomes. Therefore they have found it not so worthwhile, given the overcrowding on the market, to seek business expansion. Furthermore, this overcrowding may also have discouraged financially stronger firms from entering the market as potential rivals.

Given these self-reinforcing patterns, the specific "too many–too little" syndrome experienced among small undertakings in Hungary today will not necessarily and automatically change with the disappearance of the original causes. Unless an effective remedy can be found, it may grow into a self-sustaining phenomenon, a kind of low equilibrium trap, which will place a constraint on the transformation for perhaps a long time to come.

Countering the syndrome—summary and conclusions

As was mentioned in the introduction, the majority of economists in Hungary, dazzled by the euphoria of systemic change in the making, expected that liberalisation of private undertaking would rapidly release enormous business energies accumulated in the second economy. That heightened expectation was based, however, on an overestimation of the positive aspects of the second economy heritage and on an underestimation of the significance of the negative heritage.

Even today many economists see their earlier optimistic expectations as having been justified by the burst of self-employment in private and family undertak-

ings. However, more might be dissatisfied with its present record of development. Nonetheless, in general economists consider the small business sector to be a relatively successful sector of Hungary's present-day economy and regard its development prospects as promising. I, however, interpret this same sudden proliferation in another light. More precisely, it indicates a process of overpopulation and overfragmentation of small businesses, threatening the Hungarian economy with a new type of dualization that endangers the longer-term prospects of economic transformation. My assessment that the small business sector is indeed undergoing marginalization is based, in part, on findings reported above, such as (1) a much-expected business expansion of small undertakings has failed to occur, (2) part-time businesses are not on the wane but, in fact, are now preponderant in this sector, (3) hidden and unregistered small business activities show no signs of retreat.

The said danger of dualization—which I attribute in part to the inherited economic mentality of state socialism, in part to the contextual effects of the transformational crisis—suggests in my interpretation a possibility that small businesses might become a burden on the economy instead of acting as an agent of economic growth. In this situation I think it naive to expect a breakthrough involving improvements such as the reduction of high tax rates, tax relief for business investment, lower interest rates, more favourable credit repayment terms, and similar financial and tax incentives. These are "carrot-dangling" policies which, coupled with other means of alleviating recession, could at least serve to effectively stimulate small business expansion in the descending line of the business cycle in an otherwise stable market economy environment.

Given the current precarious situation of the budget and of commercial banks, Hungary scarcely has the resources to throw in such directions. Should any government still insist on doing so, we should expect nothing more than marginal improvements. In addition, even where such incentive measures were to be complemented by a get-tough policy against the hidden economy we could not expect an end to widespread tax violations. More energetic "big sticks" are not likely to have far-reaching demonstration effects in a situation of generalised income concealment.

However, if similar measures cannot provide an effective remedy for the "too many–too little" syndrome and the trend to a new-type dualization of our economy, is there a hopeful possibility (or any hope at all) of eliminating this syndrome? I trust this task is not insoluble, but in order to solve it we must sensibly take into account the historical and contextual determinisms of small business development in this country.

These determinations would, in my view, call for a "three-quarter" turn in policy concerning small businesses, a new government strategy which would place its main thrust behind three measures: (1) promotion of sectoral-regional integration of small businesses, (2) reduction of unemployment and elimination of excessive job rationing on the labour market, (3) reduction of the fever of establishing small businesses.

(1) As regards the furtherance of integration as the first element of the overall strategy proposed above, I do not have in mind another office of small business administration—as if entrepreneurship could be established by government tutelage or state largesse. Such offices are superfluous and low in efficiency; and insofar as some are more efficient in the short term, they are more dangerous in the longer, for they are all the more likely to stifle the spontaneous self-organisation which is of such vital importance to the small business sector.

More suitable means of promoting concerted action by small entrepreneurs *vis-à-vis* banks as creditors, and *vis-à-vis* larger firms as suppliers or buyers, are the dissemination and popularisation of, and support for incipient self-organisations and the provision of services to aid them. The task is not one of persuading banks to be more generous in granting credit for small businesses; nor, as some advocate, should new venture capital institutions be artificially stimulated by state funds or government pressure on the banks. The viable path in the longer term can only be for small businesses (as illustrated in my earlier conclusions about the Italian, Japanese and Latin-American examples) to increase their horizontal and vertical integration and to embark on a course of expansion.

(2) I come now to the second task of the proposed strategy, namely efforts to reduce unemployment and curb excessive job rationing on the labour market.

As I have indicated, the virtual guarantee of continued employment for those at workplaces secured against closure on the one hand, and virtually endless unemployment for those displaced from jobs on the other (which together perpetuate a strong wage-inflationary pressure despite a high rate of unemployment), generate the current trend to dualization. This is because they contribute to making small entrepreneurial status a blind alley, a ghetto-like enclosure, a special space of socialisation from which there is an ever-decreasing likelihood of return to regular employment.

I grant that our high rate of unemployment is in large part a natural concomitant of the long-drawn-out transformational crises, although I think it could have been quite a bit lower if Hungarian firms and trade unions had shown more wage-restraint. I also acknowledge, moreover, that our extraordinary job security at places of employment with continuing stability has roots in general problems well known in the literature on labour economics, notably: difficulties in assessing actual skills when screening job applicants, costs of workforce replacements, and other sources of insider bargaining power. Yet acceptance of these partial causes does not justify the present inaction on the basis of (false) expectations of the job-creating effects of an imminent economic revival.

In fact, if wage inflation remains unconstrained, and if the various factors contributing to insider power are left unchanged, there are good reasons to expect that the higher demand for labour that accompanies growth will fuel wage inflation rather than immediately create new jobs. The plausibility of such a scenario is additional justification (alongside a more proportional distribution of the burdens

of unemployment and efforts to preserve the value of human capital embodied in the jobless) for policy measures to check wage inflation and to spur two-way flows between the working population and the jobless, with the aim of mitigating the causes of economic dualization.

I understand that in a context of a two-digit unemployment rate it may sound odd to warn about a danger of wage inflation. Still, I hope that this time in Hungary, under the conditions just described—and in the light of last year's experience when parallel to an additional reduction of employment by some 250,000 persons, wage inflation exceeded, and continues to exceed, price inflation—such a proposal will meet with a more sympathetic response.

(3) In contrast, I cannot be optimistic about the likely response to my advocating the reduction of the fever of establishing small businesses: this would require the institutionalisation of some sort of "birth control". I am even prepared to be accused of the ultimate sin of rejecting the principle of free entry into the market as a fundamental value of a market economy.

To be sure, I have in mind no bureaucratic constraints, no restoration of the right of administrative review of applications for an entrepreneur's licence, nor even a fixed number of permits (like the medallions issued by western cities to prevent an undue rise in the number of taxi drivers). I do not believe that the desirable rate of small business density can be decided, except in some special fields of activity, by administrative discretion. What I have in mind is to institutionally increase the costs of establishing a new undertaking: instead of "free entry", I am proposing and "entry fee". This might even be combined with an "exit premium", set at a fraction of the price of admission and payable for a short transitional period to entrepreneurs going out of business.

Such an entrance fee would not only reduce the gross inflow, it would also improve the quality of new entrants by serving as a screening device to filter out people liable to venture upon an undertaking at a momentary impulse, without thinking through means and ends. By screening out people attracted to an "entrepreneurship" without investment or risk, moreover, it would shift the composition of new business entrants toward those more capital-intensive fields of activity where the entrance fee is a comparatively insignificant item in the total volume of start-up capital needed for an undertaking.

My proposal, it should be noted, is not based on a supposition of some positive relationship between the ability to pay an entrance fee and the possession of entrepreneurial capability. Whether or not such a supposition has validity, its technocratic justification is not what is being suggested here. Instead I would suggest two alternative, and complementary, rationales which are less in conflict with our concepts of social justice, economic efficiency and desirable state involvement in a market economy.

— According to the first rationale, the entrance fee may be seen as a special "environmental pollution tax" serving to internalise the negative external effect

of a growing crowd of new entrants. If my central thesis of overcrowding in the small business sector is accepted, it seems reasonable that each prospective entrant should pay for the total damage to society from the growth of overcrowding caused by him—damage which he would otherwise suffer from to only a minimal extent.

— The second rationale starts from observed asymmetry in which insider employees are, as I have pointed out earlier, protected from outside competition to the detriment of the self-employed. Raising the costs of entry into self-employment can also be considered as a counterweight to this unjust asymmetry by providing a similar protection to the insider self-employed. If the entrance fee is justified (and made necessary), in part, by the existence of insider power on the labour market, it follows that the entrance fee should (and could) be reduced in proportion to the opening up of the labour market and finally abolished with the elimination of the said asymmetry.

The receipts from entrance fee, augmented by some reasonable normative support from the budget, should naturally flow back in full to the small business sector. Entrance fees could thus promote elimination of the "too many–too little" syndrome not only by serving to check inflow into self-employment but also by providing additional resources for the expansion of small businesses.

A final component of the proposal is that entrance fees will be set (and their utilisation determined) by organisations representing the self-employed. This will thereby promote the self-organisation of this economic sector, also stressed as a main strand of the proposed strategy. This arrangement would at the same time provide a mechanism for sensitively adjusting entrance fees to the degree of crowdedness of small businesses as it varied in time and space. The apparent disadvantages to small entrepreneurs' interests in setting prohibitively high entrance fees designed to exclude entry (even at the price of no receipts) might be offset by increasing their interests in maximising receipts (garnished from the higher numbers of entrants). These conflicting interests would provide a good basis for reaching consensus on an amount of fee close to some optimum from the perspective of development of the small business sphere.

Finally, this flow-back of receipts from fees, together with the described mechanism of collective decision-making, enhances the likelihood that the proposed entrance fee could function as a positive pre-screener in yet another respect. The longer the period that someone anticipates remaining an entrepreneur when considering entry, the greater his hopes of recovering his entrance fee from the amount of fees to be paid by later entrants (and influenced by himself as well). It would pay less to base an undertaking on a plan to make the most of only momentary possibilities. Consequently, the entrance fee could give an added impulse to self-employment, encouraging it to embark on a new course of development which would retard the excessive proliferation of small businesses in Hungary and remove the acute danger of economic dualization.

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FIRM BEHAVIOUR DURING A LONG TRANSITIONAL RECESSION

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There are no new theorems or statements in this study. Everything can be found about firm behaviour in textbooks on microeconomics or marketing. The description and interpretation of ongoing processes, and the presentation of trade-offs appearing in the Hungarian economy have been borrowed from forecasts, articles and country studies prepared by international organizations, Hungarian research institutes, and policy departments of government organs. However, my aim here is not merely to present well-known ideas and standpoints. By sequencing and editing the above-mentioned material and its data I hope we might improve our knowledge about the nature of the present transitional business cycle.

The methods of adaptation

Firms, as players on markets of differing size and equilibrium position, can pursue different aims.[1] However, in one thing the small firm seeking maximum profit in the local market and—just to mention the opposite end—a monopoly having (under the national plan) a responsibility for provision are equal: some exceptional cases apart, they are not helpless subjects of the changing environment. Firms make their decisions—contrary to the frequent assumption of behavioural models—relying not on one piece of outstanding information (the central plan, the price of inputs and outputs) but on a large body of information assembled by using variegated methods. The well-informed corporate decision-maker can modify more than one or two variables. (Model builders prefer price and/or market share.) Corporate management knows and applies many tools and methods and, to an even greater extent, a combination of them. This enhances the likelihood of successful adaptation to changing market conditions and macroeconomic regulation.

Individual groups of firms, markets, economic systems or cultures have their characteristic answers (corporate strategies, business plans, policy packages), but there are no two equal business plans or corporate strategies. The art of management is precisely to combine, within the "package", the individual tools and methods in the right proportions.

Hungarian firms responded with compound policy packages to the recession of 1989–1992, as well as to the dramatic shrinking of their markets. The most frequently used tools of adaptation were:

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[1] A good summary on this is *McGuire* (1964).

— price increase
— change of product
— increase of sales
— capacity enlargement, conversion (investment)
— increased market share on certain markets (partial or total change of markets)
— reduction of costs (e.g. through diminishing inventories)
— delaying or defaulting on payments due (forced credit)
— delaying or default on payment of taxes and dues
— organizational changes
— production for stock
— reduction of workforce
— renting or leasing part of corporate assets

The methods mentioned above are not cases of either positive or forced adaptation. A well-known example of positive adaptation occurs when a firm rids itself of loss-making products and divisions. This always requires the sale of some assets and the firing of some workers. To produce for stock, or the accumulation of stocks are not always necessities: maybe it is rational to delay or to bring forward buying or selling because of an imminent price rise. Market switching might be a sign of being ousted from old markets, or invading new ones. Only a detailed analysis can show whether an action increases the profit or market share of a firm, or serves only the goal of survival—i.e. of forced adaptation.

If they can choose, corporate managers prefer certain methods over others. They feel more successful if they raise prices than if they pile up stocks. They feel more self-respect if they can avoid redundancies than if they cannot. It does not contribute to their authority if they are mentioned on the lists of banks, social security organisations, the customs or the tariff office as unreliable debtors or late payers. They prefer investment to the sale of assets etc.

These preferences and non-preferences of corporate managers might be explained only partially by prestige and moral considerations. More important are rules-of-thumb learned during managerial practice. Experienced managers know exactly which are the best steps for gaining time, or for stretching the period of adaptation. These steps are consciously distinguished from methods offering the possibility of long term solution. They equally distinguish easily reversible measures from irreversible ones or ones which are hard to reverse.

The preferences and experiences of managers are different, and therefore the opinions that exist among managers are divided—even in stable market economies where rules are settled. This is increasingly true in a period of rapid transformation. Therefore, in what follows, if statements are made about Hungarian managers, such

statements will always be true (in my opinion) about the overwhelming majority of them.[2]

Managerial rules-of-thumb, business plans and strategies assembled by adhering to prestige and moral considerations have a strong impact on the business cycle: "firms may delay the consequences of concentrated outside shocks in several ways—from production for stock through indebtedness, to eating up reserves or faking liquidity with loss-making exports. If the time gained is used for true adaptation it might be rational, even if it causes high transitory losses. However, if it results in no more than the delay of bankruptcy, in accumulating losses, or in spreading liquidity problems to other firms, then its effect on the given firm is a later, more gradual, dragging recession. This remains for a while, even after the easing or disappearance of the outside shock." (*KOPINT-DATORG* 1991, p. 82)

The indicators of solution and of delay

In what follows we shall review some time series. All of them are a form of aggregate of corporate activity (naturally, leaving out the unregistered performance of the underground economy). Some of them measure the spread of crisis management, others the spread of delaying methods that were observable in the period 1990–1992. In the assumption here, the rapid or accelerating spread of solution methods and/or the slowing down or decelerating spread of delaying methods show that the Hungarian economy is getting out of the recession and the chances of revival are improving. If the spread of methods for solution is retarded and the delaying methods spread rapidly at an accelerating pace, then we should conclude that the recession is dragging on and deepening.

The aim here is not to ask what causes revival, or the price of revival. However, it should be mentioned that the spreading of methods for solving corporate problems does not necessarily improve the situation of households. The reverse can also happen: there are delaying methods which improve for a while the otherwise grave situation of many sections of the population.

Among methods for coming out of the corporate crisis, managers usually include price increases to boost income, increased sales, getting out of shrinking markets and entering new regional and product markets. An important element of market success is product, marketing and organizational innovation, and the investments that assist them. Cost reduction through reorganisation, or reduction of inventories, also contribute to the solution of the corporate crisis.

[2] Rapid change of values is demonstrated by the fact that managers who previously tried to avoid employment reduction at a state firm, now, as private firm managers, ruthlessly fire workers they do not need. Also important is the fact that in the Hungarian transition so far, many more managers have become proprietors than would be expected in a settled market economy.

On the other hand, the methods for delaying the crisis include forced crediting among firms[3] (queueing), production for stock (taking short-term credit to finance it), and late payment of taxes and insurance.

Lay-offs and the sale or lease of corporate assets are not delaying methods in the opinion of analysts from developed market economies. Nevertheless, we should take into account that in the reformed Hungarian planned economy layoffs and sale of assets were never used as methods for solving the corporate crisis (unlike the other methods mentioned above, whose implementation had been regular practice for Hungarian managers since 1968). Therefore layoffs and sale of assets were—if possible—avoided by Hungarian managers in the period 1989–90, if for no other reason than the fact that these managers were unfamiliar with such instruments. On top of that, layoffs and sale of assets had a large political risk at the time: for instance, there were political campaigns against the sell-out of assets and the conversion of political power into business power; also popular opinion was totally against unemployment.[4] Therefore, in Hungary today layoffs and the sale of assets are symptoms of intensifying corporate crisis (i.e. the ineffective nature of other solving and delaying methods), rather than that of conscious crisis management. To put it otherwise: in our case, their spreading is more a sign of this intensifying crisis than an indicator of imminent revival.

Methods for solving the corporate crisis

Raising prices

Hungarian firms experienced relatively early (in 1987–88) the shrinking of the CMEA and domestic markets. Many firms reacted to this challenge by raising prices. In doing this, they relied on their monopoly position, on the several decades of the long helplessness of buyers, and on the shortage on several markets (*Table 1*).

In 1989–90 industry had almost no branch where prices had not been raised at an accelerating pace. However, in early 1991—first in meat processing, then in the whole food industry, and a few months later in several branches of light industry and in telecommunications and vacuum technology—prices decreased by a few percentage points. In the second half of the year the price index of the chemical industry and extraction decreased somewhat. As a result, industrial prices in the second half of 1991 grew by a mere 2–2.5 percent, and from September they virtually stagnated.

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[3] Some of involuntary credits and queueing are of a speculative nature, and have not been induced by the crisis. Among firms assessed by the Hungarian National Bank (see later) this factor is not important.

[4] According to a public opinion research poll 39 percent of respondents thought that able people should not lose their job. (*Hann and Laki* 1992, p. 186)

Table 1

The price indices of industry
(previous year or month=100 %)

Year, month	Domestic sales prices
1988	104.1
1989	113.4
1990	124.2
Jan–Dec. 1991	131.8
Jan–Dec. 1992	109.7
1991	
January	108.1
February	103.6
March	101.7
April	100.6
May	100.6
June	100.5
July	100.9
August	101.1
September	100.0
October	99.9
November	100.6
December	100.5
1992	
January	101.3
February	100.8
March	101.4
April	100.9
May	101.1
June	100.7
July	100.7
August	101.4
September	101.1
October	101.9
November	101.0
December	100.3
1993	
January	102.7
February	100.8

Sources: *Statisztikai Havi Közlemények, Dec. 1991 and 1993, Nos 2–3.*

In 1992 the slowdown of price increases continued: the level of price rises on an annual basis was 9.7 percent. True, in the second half of 1992 and in the first

months of 1993 monthly price rises were hardly more than in the first half of 1992; however, the raising of prices was less and less appropriate as a method of crisis management.

The case was similar on foreign markets. Sales prices of industry grew in 1991, albeit slower than domestic sales prices in general. The export prices in industry grew at a slower rate in 1992 than domestic prices. This means that in foreign trade price rises slowed down more than average. (*Table 2*).

Table 2

Producer-procurement prices of agricultural products (previous year or same period of previous year=100 %)

Year	Plant and gardening products	Live animal and animal products	Total
1988	100.0	106.4	103.6
1989	114.2	122.8	119.1
1990	135.0	124.4	128.5
1991			
January–June	128.7	99.5	101.5
January–July	106.0	98.9	100.5
January–August	102.4	98.5	99.5
January–September	101.8	98.5	99.5
January–October	100.3	98.9	99.4
January–November	99.1	99.1	99.2

Source: *Statisztikai Havi Közlemények*, 1991, No. 11.

In agriculture the price of crops produced grew relatively rapidly, in 1989–90 but already at the time there were serious marketing and price problems with viticulture and wine production. The turnaround with crop cultivation in general occurred in mid-1991. Unlike in previous years, in the second half of the year procurement prices did not rise but practically stagnated. On the market of live animal and animal products the pace of price rises was much lower in 1990 than the rise of the consumer price index. In 1991, especially in the second half of the year, prices decreased. Particularly low were the procurement prices of pork and cattle. The former was, between January and November of 1991, 94.2 percent of the same period one year before, the latter 85.8 percent. Price reduction was not caused by increased production: "In 1991 the output of animal husbandry was 6 percent less than in 1990." (*Gazdaságkutató* 1991, p. 15)

In 1992, the processes at work in agriculture were different from those in industry. The producer-procurement price index of agricultural products had, in 1992, already grown by 9.7 percent. In the second half of 1992 there was a particularly rapid rise in the price of live animals. Thus "partial forward shifting of surplus

costs onto prices was unavoidable." (*MNB* 1993, p. 18) Agricultural firms' room for manoeuvre increased but the possibilities for price rises were limited. Procurement prices in agriculture grew slower than the consumer prices of food.

In construction already in 1989 and 1990 the rate of growth of prices was considerably lower than in industry, agriculture and consumption. In 1989 in building construction the price rise was 9.6 percent, in industry 13.4 percent, in agriculture 19.1 percent, and the consumer price index was 17.0 percent. In 1990 there was a similar lag: agricultural procurement prices grew by 28.5 percent. There was no sign that this lag could abolished in 1991. In 1992 the chances of price rises improved in construction too: "Compared to the 19.2 percent price rise in 1991, in 1992 (according to preliminary calculations) construction prices grew by 27 percent." (Gazdaságkutató 1991, p. 13)

The chances of increasing sales

In the three industries that were in a position to determine the performance of the Hungarian economy, the possibilities for price rises were exhausted by 1991. In 1992, in industry the opportunities for price rises diminished somewhat, but in agriculture and construction the chances improved. In the growth of sales this lopsided feature was not apparent. The explanation is the dramatic decrease of sales across the board. As it turns out from the table below, in 1991–1992 the output of every branch of industry decreased. (*Table 3*)

Table 3

Production in main sectors

(previous year or same period of previous year=100 %)

Sector	1989	1990	1991	1992
Industrial production	99.0	90.4	85.9	90.2
domestic sales			83.4	92.9
Agriculture			84.4	
Plant cultivation	98.9	90.7	104.8	73.7
Animal husbandry	97.5	99.18	81.7	
Construction	98.9	84.7		
Transportation of goods			74.6	

Sources: *Statisztikai Havi Közlemények, 1992, No. 1;*
Magyar Statisztikai Zsebkönyv, 1992.

Industrial production in 1991 was only 85.9 percent of that of the previous year. Particularly grave was the situation in industries producing investment goods:

in engineering in December of 1991 production was only 60.5 percent that of the previous year; in vehicle production the equivalent figure was 45.0 percent; and in the production of building materials it was 52.9 percent. Also larger than average was the decrease experienced by producers of agricultural inputs. The output of fertilizers and pesticides in December 1991 was only 57.9 percent that of a year before. Production follows the trend of sales: domestic sales of industry decreased between January and December of 1991 by 20 percent.

Agricultural production and sales have been decreasing for several years. Particularly dramatic was the decrease in the sale of animal products.

In construction, the third large branch of industry, it was noted that "strong recession has been going on for two years. The decrease of output this year (in 1991—M.L.) was similar (equally grave) to that of last year: the volume of finishing fell back by 6–7 percent, and that of building construction by 8–10 percent" (Gazdaságkutató 1991, p. 13)

There were no changes in the market for construction in 1992: finishing activities in building construction in the period from January to September 1992 stood at 91 percent of the similar period one year before. The performance of the construction industry in 1992 was characterized by the fact that "investment in construction grew in current prices by 1.1 percent, which means a considerable fall in volume considering the 27 percent price rise in construction." (MNB 1993, p. 14) Housing construction decreased even further: in 1991 33,164 flats were built, some 10 thousand less than in 1990. In 1992 there was further negative record: between January and December only 25,807 flats were built. The decrease relative to the previous year was 22.2 percent. (*Statisztikai* 1993, p. 31)

Switching markets

Time series of production and sale show that the majority of Hungarian firms hardly enlarged their sales in 1990—and their performance was even lower in 1991–1992. The data measure the extent of actual market growth and not the firms' capacity to expand. According to the unanimous view of experts, the decrease in production would have been much larger had the Hungarian firms not switched markets and replaced collapsing CMEA markets with growing Western ones.

The pace and extent of "market switching" is impressive indeed. In 1989 CMEA exports totalled HUF 320 billion, in 1990 only HUF 160 billion, and in 1991 HUF 130–132 billion. The figures show a slowing down in the shrinking of this market. The 30 percent decrease in 1990 was followed in 1991 by a "mere" 21–22 percent shrinking. The slowing down was also experienced in 1991 too: whereas in the first half of year the shrinkage was 21–22 percent, in the second half it was 16–17 percent.

A large number of Hungarian firms were not surprised by the collapse of the CMEA market. In order to keep the Eastern markets there was strong lobbying, but at the same time firms rapidly increased their exports to the West. (*Table 4*)

Table 4

Exports to the West

(previous year or same period of previous year=100 %)

Year	EEC	EFTA
1989	127.0	125.0
1990	136.8	119.0
Jan–Dec 1991	168.0	191.5
Jan–Dec 1992	114.3	103.1

Sources: *Statisztikai Havi Közlemények, 1992 No. 1; Statisztikai Havi Közlemények, 1993 No. 1; Konjunktúrajelentés 1993 No. 1. KOPINT-DATORG.*

As *Table 4* shows, in 1989–1991 Western exports grew rapidly. Within this increase, the exports to the Common Market—whose importance for total exports is paramount—progressed at an accelerating pace. The share of non-Eastern sales in Hungarian exports grew from 71 percent in 1989 to 80 percent by 1991.

We cannot err by stating that optimistic evaluations and the expectation of the government and certain experts were based on this undeniably successful market switch. They thought that the Hungarian economy had suffered its largest shock in 1990, while in 1991—although still large—it was already smaller. In their opinion this market collapse was a unique event, not a recurring one. If the economy did not collapse under its spell, why should it in 1992–1993 when such negative shocks were nowhere in sight?[5] According to certain assumptions in the second half of 1992, economic recession would at worst be replaced by stagnation, and at best even a certain level of growth: "Our forecast departed from the fact that the bulk of the market switch has already materialized, that the number of ventures in the modern partnership form is growing dynamically, and the inflow of foreign capital continues. Besides these factors, after a huge recession, it is much easier to produce some growth." (*Báger* 1992)

If we compare the time series of domestic production and sale with time series of CMEA exports we can discern an interesting time delay: the spectacular reduction of production occurred not in 1990—the year of collapse of the CMEA market—but later, in the second half of 1991, in the period of slower shrinking of

[5] György Osváth, the advisor to the Prime Minister, expected recovery. (*Osváth* 1992) A more cautious optimism was illustrated in the mood of the article by dr. Béla Kádár, which appeared early in 1992. (*Kádár* 1992)

Eastern markets. This had been caused to a large extent by "abrupt, forced market switching in 1990 ... which primarily concerned firms that had several decades of old and direct (firm-level, cooperative) contacts with firms of developed market economies, and therefore were able to react rapidly ... This year (1991—M.L.) the pressure of market switching was already being felt in industries and firms where the conversion of production requires large investments, a relatively longer period of time, and above all the rekindling of capabilities that had atrophied during the last forty years." (KOPINT-DATORG 1991, p. 95) It was a sign of the slowing down of market switching when it was noted that "in mid-September 1991 industrial firms had never before had such a low stock of orders." (Gazdaságkutató 1991, p. 10) Orders went back first of all in domestic markets—here the decrease compared to the base period was 33 percent. Export prospects according to the already quoted report of the *Gazdaságkutató Intézet* (Economic Research Institute) were no good either. The stock of export orders was down by 18 percent in the second half of 1991.

The decrease of the stock of orders shows that the increase of exports to the West has slowed down considerably. "In 1992 data on export sales indicate a break in the export expansion of previous years. Dollar export income grew by a mere 7.4 percent (in 1990 it was USD 15.5 billion, in 1991 USD 37.1 billion). On top of that, the seasonally adjusted sales data for the last quarter show a decrease in exports relative to the same period in the previous year." (KOPINT-DATORG 1993, p. 11) The stock of export orders in October 1992 was a mere 48.9 percent of that of a year before. Thus it is no wonder that in first semester of 1993 exports to the West (i.e. for USD) did not grow but fell: "In the first four months of the year USD 2.46 billion worth of goods were exported by Hungarian firms what is 73 percent of the result of the previous year." (*E. F.* 1993) In the second half of the year the situation did not improve: the year 1993 was closed by a record USD 3.5 billion deficit in the trade and current account.

The decrease of exports can be explained by a unique coincidence of events: the recession that hit the developed market economies, the revaluing policy of the Hungarian National Bank (Oblath 1993), and the non-fulfilment of expectations concerning the growth of exports to the East. The bankruptcy law also contributed to the spectacular fall in exports. However, perhaps the most important cause of export exhaustion is that more and more Hungarian firms have fully used up the capacity of their existing machinery, knowledge and possibilities for short-term adaptation.

Product and organizational innovation

One of the most important ways of market switching or, more precisely, conquering new markets, is to offer new and competitive products. There are no fresh data on this activity of Hungarian firms, nor is there anything up-to-date about the share of new products and services. With regard to markets for individual goods—primarily where the presence of flexible private and mixed property firms is intensive (e.g. computers, tourism) or where the Hungarian producer is under pressure from import competition—the quality of products has improved, and traditional market actors have frequently offered new services and new products.

It is a sign of product change that domestic production of certain products (radios, phosphatic fertilizers, tyres) has been abandoned, whereas at other firms the output of other products (passenger cars, floatglass, soft drinks) has increased rapidly. It is difficult to estimate the extent of product change. However, one should be cautious. According to the Venture Promotion Council "only 1.1 percent of new domestic ventures established more than two years ago have, over those two years, made any innovation or technological investments. According to another survey, even innovation based firms, producing a patented new product, have neither the energy nor the money to develop a second product." (*SZ. A.* 1993)

It is difficult to evaluate or measure the extent and importance of the changes. Nevertheless, one should be cautious with such statements as: "the export shares of individual industries did not change much. From among the previous large exporters, neither the forint value nor the share of metallurgy, engineering, chemical or light industrial exports changed much, relative to the same period of last year (1990)." (KOPINT-DATORG 1991, p. 22)

There was no breakthrough in the competitiveness of products either. From among the statistically assessed 77 important industrial products, in 1991 production grew in only 13. In 1992 this ratio was more or less the same: from among 79 important products and product groups the production of only 16 grew. It is also well-known that several large firms, industry- or academy-affiliated R+D institutions, departments and subsidiaries have similar or more serious problems than the production firms. To rescue the physical and intellectual capital that was tied to projects that served the needs of CMEA, Soviet industry or the Warsaw Pact, and then to convert them into products fulfilling the needs of competitive markets, is a time- and money-consuming task.

Beyond product- and service-innovation, where changes can be expected to be modest and gradual, in the area of organizational innovation there has been an explosive change. (*Table 5*)

Since we have no data about the assets and income of new firms, and know nothing about the incomes earned by establishing new firms or selling the assets of old ones, it is difficult for us to assess the importance of such actions. There are big differences between estimates. According to György Matolcsy "with full

Table 5

The number of business units

Type of organization	1990	1991 December	1992	1993 February
Organisation with legal entity	29470	52736	69386	7243
Foundation (yearly)	14867	24275	18052	
Liquidation (yearly)	632	989	1422	
Business partnership without legal entity	27571	44279	60762	65689
Private venture		419662	606207	619264

Source: *Statisztikai Havi Közlemények 1993, Nos 2-3.*

transformations and partnership foundations that are now in process, state assets worth HUF 300–350) billion will be transferred by the end of 1991 into transitional venture forms." (*Matolcsy* 1991, p. 129) According to Péter Vince, however, by 1992 "only 2–3 percent of the HUF 1888 billion worth of state assets (at book value) had been privatized". (*Vince* 1991)

There are different opinions about the popularity and feasibility of organizational innovation as a means of crisis management.[6] The optimism of the already quoted government experts is based on the rapid growth of the number of firms. A certain group of new firms have increased their sales very forcefully. However, a significant number of these firms are really "shadow firms", whose aim is not to earn profit but to use the loopholes in the tax and the tariff system.[7] Equally important is the danger that new, private and mixed property firms "pick and choose among the healthy divisions of the firms and leave the bankrupt ones and the debt to the state". (*Sárközy* 1993) Thus it may increasingly happen that low efficiency capital will remain the responsibility of the state, and this will result in the exhaustion of the whole privatization process.

In 1992 there was a continuation of the long explosive changes that had been going on for several years; the number of business organizations further grew, but within this the number of state property firms slowly diminished. The number of business organizations with legal entity (limited liability companies, civil law

[6] On the speed of privatization, apart from the already mentioned work of Matolcsy, see Kornai (1991). A dissenting view is Laki (1992).

[7] An increase in the number of firms is an important, necessary precondition for changes in the system of procurement. Measurement of the benefit of trade innovations is as difficult as measurement of product innovation. There are no comprehensive data about the spread and impact of trade innovation, but there are stories about firms losing their majority market share due to the appearance of new flexible competitors (perfumes, tourism etc.). The appearance of new organizations has compelled the old players to remake their internal structure and their incentive system (i.e. their organizational innovation).

partnerships) grew, but this growth was slower in 1992 than in 1990–1991. In 1992 not so many of these organizations were established as had been a year earlier, whereas the number of liquidations grew relative to the earlier period. This does not mean that organizational innovation has exhausted its capacities, since the number of business partnerships without legal entity (limited partnership, ordinary partnership) grew extraordinarily in 1992.

The techniques of gaining time

Stockpiling

In 1989 inventories in the Hungarian economy decreased by 3.4 percent. In 1990 this decrease turned into an increase, and stocks stood at 119.9 percent of the level of the previous year. In 1991 the stockpiling process accelerated, and inventories were 150–160 percent of those of the previous year. "A large number of economic actors produced for stock, in expectation of a livelier market. Very probably the growth of stock has been reinforced by the strong increase of imports and the devaluation expectations of importers. The decrease of domestic final consumption and accumulation resulted in high trade inventories. The level of stocks has been added to by extraordinarily good results in plant cultivation (or with marketing problems of this produce)." (Gazdaságkutató 1991, p. 33) It is undeniable that the unfounded expectations of some entrepreneurs caused stocks to swell even further. However, this extraordinary and rapid growth cannot be explained by recurrent managerial error. The growth of stocks is only partially explained by market switching—i.e. the larger unit stock requirement of Western exports relative to former Eastern exports. It has to be mentioned that among the other causes is the fact that some firms tried to gain time in their fight against corporate crisis by piling up stocks. The "transitory swelling of stocks was able to channel troubles resulting from abruptly diminishing sales prospects, but only for a short period." (KOPINT-DATORG 1991, p. 72) Therefore, by 1992 this method was hardly being used, for at that time "sales regularly exceeded production". (KOPINT-DATORG 1993, p. 85)

Involuntary crediting among firms

Firms tried to finance the swollen stocks not only by taking short term credit but also by forcing one another into giving credits. The number of indebted firms and the volume of involuntary credit grew particularly rapidly in 1991 (*Table 6*).

Table 6

Involuntary creditinig

Year	Number of involuntarily crediting firms	Amount of involuntary credits HUF billion
1989	314	72.8
1990	432	90.5
1991	1017	159.8
April 1992	1143	197.0
December 1992	642	104.0

Source: *Várhegyi and Sándor* (1992, p. 25)

To lose one's reputation as a good debtor is something managers try to avoid. The accumulation of debts destroys long-term business contacts, spoils the faith in the firm, and thereby deteriorates the prestige and market value of managers. Indebtedness is not a lasting cure to the ills of a firm (it is an even worse "cure" than stockpiling), and, at most, it does no more than lengthen the period of adaptation. Therefore the growth of the stock of involuntary credit, and the number of queueing firms, signals not only liquidity problems but also diminishing opportunities for an important and increasing group of firms to find a lasting solution to the crisis.

The volume of involuntary credits, and the range of firms concerned, grew rapidly up to mid-1992. Thereafter there was a learning process similar to that which occurred in the case of stockpiling. Seeing the large volume of bad credits and the large number of bad debtors among the sellers, banks became ever more cautious. In fact, more and more firms tried to leave the queue, and therefore by the end of the year the range of firms involved and the amount of credits concerned had diminished perceptibly.

Delaying budgetary payments into the budget

Perhaps the most important form of gaining time is tax avoidance and delaying tax payments. A higher than planned deficit in the budget is mainly caused by errors in estimating the business cycle (financial planners regularly assumed there would be an increase in GDP instead of a large decrease), but concealment of taxes and late payment might have a role too. "There were important arrears over the years in the payment of corporate taxes, in profit tax and reserve payments of financial institutions, and there is a more than HUF 10 billion worth of tax and customs arrears." (MNB 1993, p. 25) There is no data about tax avoidance and tax evasion between 1990 and 1993. However, somewhat more is known about arrears and avoidance in social security and customs payments.

Arrears in social security payments grew from HUF 24 billion at the end of 1990 to HUF 43 billion by August, and HUF 53 billion by December of 1991.[8] There is no data for these arrears in 1992. However, it is known that the deficit of the social security fund grew from HUF 22 billion in 1991 to HUF 31.5 billion in 1992.[9] The growth of the deficit was caused not by a decrease in income but by rapid growth of outlay (pensions). In other words, the collection of social security contributions did not deteriorate considerably in 1992. Within this, income from contributions grew more than average—namely, by 18.6 percent in a period characterized by economic crisis and increasing unemployment.

In 1991 the customs arrears of the population and the corporate sector amounted to HUF 50–60 billion, and this figure was growing rapidly. This is also a form of gaining time. In Spring of 1992 the government started a forceful customs duty collection campaign and as a result—beyond the negligible one-off surplus income—the performance of customs collection improved considerably. The customs and import income of the budget was 24.8 percent more in 1992 than in the previous year, whereas import growth in the same period was only 12–13 percent.

New crisis management methods

Corporate crisis was not unknown in the socialist economy either. (*Laki* 1987) The methods for managing such a crisis (as mentioned above) had been known to corporate managers for decades. Under the new conditions several corporate managers have been compelled to rely on methods unknown in the socialist economy. Unlike in the socialist economic-social system, where an important element of firm behaviour was growth and expansion, under the conditions of recession more and more firms began a slimming course, "doing away with" some of the production factors.

Specialists have only a few, imprecise data on the sale or transfer into limited liability companies of some of the corporate assets. Therefore—as we have seen—there are contradictory estimates about the volume of capital withdrawn from the state sector and the speed of this outflow.

A more accurate picture about the pace of slimming can be attained if the decrease of employment and the number of the unemployed are considered. After the turnaround of 1989, managers accustomed to growth increasingly resorted to closing dawn the least efficient divisions, or those whose products were unsaleable. (*Table 7*)

[8] *Heti Világgazdaság*, October 16 1991; *Heti Világgazdaság*, January 16 1992; *Beszélő*, February 15 1992.

[9] *Heti Világgazdaság*, April 23 1993.

Table 7

Employment and unemployment

Year	Registered unemployed (number)	Vacant jobs (number)	Number of employees previous year=100
1989	12000		
1990	89000		
1991	406000	15124	86.7
1992	663000	24097	80.3
1993	705032	32471	

Source: *KSH Statisztikai Havi Közlemények 1993, Nos 2–3.*

The number of unemployed grew particularly rapidly in 1991: in 1989 it stood at 12 thousand, at the end of 1990 it was 89 thousand, and in December of 1991 some 406 thousand unemployed were registered. The share of the unemployed was 2.5 percent in December of 1990, and 8.5 percent a year later, in December 1991. In 1992 the rate of unemployment stood at 12.5 percent. (*Table 8*)

Table 8

Number of employed in 1991

	First quarter	Third quarter
	(Same quarter of 1990=100)	
Industry	89.0	87.7
Construction	80.2	79.0
Agriculture	77.8	76.4
Transport and telecommunication	91.7	
Trade	87.6	85.5
TOTAL	86.1	84.6

Source: *KSH Statisztikai Havi Közlemények*, 1991, No. 10.

The numbers show that whereas redundancies were exceptional in 1989, by 1991 they had become a general method of crisis management. More and more firms assumed the political risk and the social tension it generated and rid themselves of superfluous or inefficient production factors, this main target being labour. In most cases the laying-off of superfluous workers was not part of a forced reaction to the deteriorating economic situation, for this would have been contrary to the habits and moral considerations of managers.

Parallel with the spread of this method of crisis management, a special lay-off strategy appeared. The liquidation of plants in the countryside, the increased laying-off of young, inexperienced and indisciplined workers reminds one of the sort

of reorganization often experienced in developed countries. The slow reduction in the role of the central apparatus, and the "picking and choosing" from among the physical assets intended for sale, are not signs that there is movement in the direction of a more feasible organization of any given firm. Slimming is, in the system of terms usual in Hungary, something intermediate: it is neither a delaying nor a solving method of crisis management.

The limits of short term adaptation

Table 9

Feasibility of crisis management methods

Method	1989	1990	1991	1992	1993
Price rise	+	++	0	+	+
Output rise	+	–	–	–	–
Exports to the West	+	++	++	+	–
Switching market	+	++	++	0	0
Product innovation	?	?	?	?	?
Organisational innovation	+	++	++	++	+
Stockpiling	0	+	++	0	
Interfirm involuntary credit		+	++	–	
Late payment	0	+	++	+	
Redundancies/lay offs	0	+	++	++	

++ strong growth
+ growth
0 unchanged
– decrease
? not unequivocal

Firms tried to improve their situation by employing several methods at the same time. In the rank order and share of the methods employed, priority was given to methods which increased the fame of managers and the chances for overcoming the corporate crisis. If they were not effective enough or if there was no way of employing them, managers increasingly relied on crisis management tools that did not increase their prestige and were only good for delaying the crisis and spreading its effects over a longer period of time. Firms in such a situation ventured into the implementation of hitherto unknown tools. According to our assumptions, there was an increased frequency in the use of prestige-reducing, delaying and unknown-risky methods, and these were signs of the diminished chances for firms in attempting to overcome their difficulties. If such chances deteriorate on the whole, it means that revival is not imminent and the recession will drag on. The gaining of

ground by delaying methods at the expense of solving methods represents a type of business cycle indicator: it shows that the recession is continuing and intensifying. In 1991 delaying methods spread rapidly and in 1992 the recession was still showing its strength. (*Table 9*)

Yet what are the events of 1992 showing?

From among the solving methods only price rises were easy to employ. It is a new phenomenon that, with the most successful previous solving method (i.e. market switching), the growth of exports to the West was halted. From among the solving methods only organization innovation has expanded unabated. At the same time, however, the employment of delaying methods has also decreased. There is less forced corporate credit, and the opportunities for delaying or denying payments to the budget have been exhausted. This means that the trade-off between solving and delaying methods prevailed only for a short time—namely, in the period of *accelerating recession*. Later the spread of delaying methods slowed down or stopped as well. To summarise this section, it can be said that corporate managers had, in 1992–1993, less opportunity for making a short-term adjustment and for making choices between solving and delaying methods (especially if comparison is made with the situation a year earlier).

Investment

The exhaustion of possibilities for short-term adaptation might be a sign of an investment boom—firms have no choice other than to renew physical capital. The data, however, say otherwise. In 1990–91 the volume of investments in the Hungarian economy decreased considerably. (This was one of the causes of the larger than average fallback of production and sales in industries serving investment activities). In 1990 the volume of investments at constant prices was 92.8 percent that of the previous year (according to other sources it was 93.7 percent). The process continued in 1991. The autumn reports of business forecasting institutions prophesied a further 8–10 percent drop for 1991. "The drastic drop in the volume of investment was caused by the coincidence of several factors. The latter included the incalculability of the economic situation, the insecure position of managers, the frequent changes in the conditions of privatization, and sometimes the lack of resources (or their high cost). The cutting down of the investment outlay of the budget (education, health, infrastructure) caused a further decrease". (Gazdaságkutató 1991, p. 33) Borrowing behaviour shows how reluctantly corporate managers start new investments. (In this it is also clear that the credit policy of the banks also has a role). Whereas the volume of short term (mainly circulating capital) loans grew rapidly in 1991, the stock of maturity credits for periods longer than a year stagnated. "The stock of less than a year maturity HUF credit given

to the corporate sphere amounted at the end of October 1991 to HUF 408.5 billion. Within ten months it had grown by HUF 97.8 billion (31.5 percent). On the other hand, "the stock of longer than a year maturity HUF credit as of 31 October was HUF 218.6 billion—i.e. HUF 1.6 billion (0.7 percent) more than on January 1 of the same year. Within this the stock of investment credits stood, at the end of October, at HUF 154.6 billion, or 1.6 billion more than in early January," (MNB 1991, p. 25) Here the problem is not only that firms were compelled to spend an increasing proportion of credits originally taken to finance inventories, for it was compounded by this fact in that firms were consequently unable to take investment credits. Firms disposing of money available for investment placed—for want of investment opportunities and inclination—a large and increasing part of their capital as deposits with banks that had high and increasing interest rates for depositors. "The stock of deposits grew by HUF 18.4 billion, i.e. 16.4 percent compared to January 1". (MNB 1991, p. 25)

There was no change in this respect in 1992 either: "Investments at current prices grew in 1992 by 12 percent relative to the previous year, but in volume this meant a decrease by 8 percent. Here too the decline slowed down since it amounted in 1990 to 10 percent, and in 1991 to 12 percent." (MNB 1991, pp. 24–25) It is not a sign of increased propensity to invest that HUF investment credits taken by firms between January 1 and December 31 of 1992 went back from HUF 144.4 to HUF 136.4 billion. The already mentioned large (27 percent) decrease of investment in construction is not a new phenomenon either. (*Table 10*)

Table 10

Indicators of the investment cycle (previous year=100)

	1992
HUF credits of firms for investment (HUF billion)	94.4
Stock of orders in construction (Oct–Dec)	69.1
in engineering	40.0
industry total	71.7
Investment total	92*

*Estimated data

Source: *KSH Statisztikai Havi Közlemények 1993, No. 1*, MNB

Propensity to invest did not grow despite the lowering of interest rates in 1992. For maturities over a year the 31.5 percent rate of interest of January 1992 had fallen to 25.6 percent by January 1993. It also has to be mentioned that cheaper credit was given against more solid collateral and the administrative costs of credit were disheartening too).

Foreign investors were more optimistic concerning investment possibilities in Hungary. Foreign capital flowed into the country at an accelerating rate. Foreign investment in Hungary grew from USD 215 million in 1989 to USD 369 million in 1990 and USD 1.5 billion in 1991. In 1992 the inflow slowed down and the foreign capital coming into the country was more or less the same as a year earlier.

We cannot leave out of consideration the fact that a large part of this capital was in the form of deposits, and capital invested "was heading towards the most flexible firms whose turnover is below the industrial average." (KOPINT-DATORG 1991, p. 72) This is partly the reason why the amount of capital invested in one joint venture decreased in 1991–92 relative to 1990, even if the number of joint ventures grew. More and more investors are present on the low interest Hungarian capital market, but not many of them have started larger investments as yet.

Wait and see

In the first months of 1993 the number of vacant jobs grew (the figure was 35,760 in December of 1992 and 41,631 in April of 1993, a 16.4 percent growth). This might have been the first sign of long awaited recovery. Other indicators, however, showed that no major changes could be expected on the investment market. In October of 1992 the stock of orders decreased more than the average in the engineering and construction materials industries (these two sectors being the main contractors of investments). (Statisztikai 1993) The first quarter of 1993 corroborates the above tendencies: "The value of finishing activities in construction was HUF 27 billion in the first quarter. At constant prices this is 13 percent less than in the same period of the previous year." (*M. H.* 1993)

This demonstrates that even if the methods of short-term adaptation are exhausted, investment is still only one (although a major) tool of survival. There are other, less risky methods too. Analysts of firm behaviour know these phenomena: namely, when the entrepreneur's (the manager's) aim is not growth but muddling through. Managers and entrepreneurs who intentionally keep their firm at "low flame" operate the factors of production in a combination such that the firm produces neither optimal nor maximal profit, but maintains it ability to function, upholds its influence, and avoids redundancies. If they are lucky even their salaries remain more or less the same (Baumol 1962).

Managers of the state sector trained under the socialist system are particularly experienced and adept at capacity concealment and keeping reserves (Kornai 1956). They "conceal" factors of production such that they can easily be mobilized at short notice. New entrepreneurs who had their origins in the private sector of the former socialist economy (the so-called "second economy") were not growth-oriented either. On the contrary, they knew very well that above a certain size

the risk of a venture suddenly grows much greater. Therefore they worked out ingenious methods of concealment, keeping stock in reserve and ways to deny capacities. Thus they were less familiar with the pitfalls and risks of rapid growth. The present problems of many rapidly growing ventures are caused by the lack of such experiences.

It is no wonder that a large part of the rapidly growing entrepreneurial sector does NOT pursue growth. In the past, some of the household and auxiliary farms appeared only casually on the market. Agricultural crises tend to increase the number of the self-sufficient producers, but when assessing the chances of recovery one should not overestimate the importance of this "wait and see" strategy.

More important here are the modern, market-oriented but not growth-oriented ventures. These are ventures—called "daddy and mummy" in the literature—producing for the local market and yielding and income for the proprietor-entrepreneur which is only a bit higher than that of a skilled worker. Their number is large mainly among older craftsmen and retail traders.

Most large firms, before privatization, do not plan for growth. Without the knowledge of the intentions of the new proprietor the investment would be particularly risky. On top of that, in a significant number of cases (albeit difficult to quantify) managers of the firm to be privatized are interested not only in withholding performance but in the outright shrinking of the firm: i.e. losing markets, and spoiling its image. The decrease of demand for the products of the firm sooner or later results in a drop in their price. Thus the managers and partners concerned can buy the assets to be privatized at a cheaper cost.

Another, perhaps larger group of firms, is ready and able to grow but cannot do so due to the recession; even if it can grow it delays its investment decisions, and builds-up reserves for some other cause.

Capacity reserve

There are no comprehensive data about unused industrial capacities, but it is known that in agriculture "fallow ground grew from 100 thousand hectares of previous years to 329 thousand hectares." (M. H. 1993) In some parts of industry unused capacities have been dismantled, e.g. production lines producing exclusively for the Soviet market. Another, not negligible part of free capacities has been retained for a future recovery. Some of the workers and supervisors operating these machines have not been laid off, even such capacities are only being partially used. This "unemployed" labour force—which was kept under the socialist era for peak load periods—are at present the "reserves for recovery". This strategy is so widely used that in recent years the number of employed has regularly decreased at a

slower rate than output. Therefore "unit wage cost in industry has surpassed the rate of inflation". (KOPINT-DATORG 1993)

Monetary reserves

Labour and equipment "set aside" are easy to mobilize. The question is whether, in recovery, it will be the same products and technologies that will be in increasing demand. Those who deem such behaviour as too risky are more inclined to increase their money reserves. This is partly the explanation for the growth of deposits by firms and small entrepreneurs. A certain proportion of the deposits of the population is also from entrepreneurs waiting "for better times". (*Table 11*)

Table 11

Deposits of firms and the population (HUF billion)

	1991	1992
Deposits of the corporate sphere	381.9	462.1
Deposits of the population	480.6	656.6

Sources: *Statisztikai Havi Közlemények 1993, Nos 2–3; MNB Havi Jelentés 1993, No. 1*

Capital that is not ploughed back into the economy can also materialize in other forms. There are many signs that capital frozen into precious metals, works of art and real estate is considerable.

Organizational forms restricting growth (investment)

It is a special form of holding reserves, as well as delaying, when the smallest possible firm is established, and then, if it attains a certain size, it is dissected. In the case of joint ventures "the size of the firm and the base capital per firm—and within it foreign capital—decreased (in 1992 relative to 1991—M.L.). The former fell from HUF 52.2 million to HUF 17.2 million, the latter from HUF 23.6 million to HUF 12.5 million. Two thirds of all the joint ventures were established with the minimal possible capital. (At the end of 1991 this ratio was 37 percent)". (MNB 1993, p. 23) These changes might have to do with the changing composition of investment (inasmuch as trade needs less start-up capital than industry), but also with the fact that the primary goal of new firms (in the short run) is market presence and not growth.

Conclusions

With the lasting nature of the current recession ingenious managers and entrepreneurs face a decreasing number of opportunities that enable them to rely on tools that can be easily mobilized in order to solve or delay the problems of their firms. The exhaustion of the reserves of short-term adjustment has not led to an increase of investment. A large number of Hungarian firms do not pursue growth. Firms which have the potential to grow are kept by managers at "low flame". This is important to know for policy-makers heralding recovery or a change of fortunes: reduction of taxes and rates of interest and other measures favouring entrepreneurship have an impact on investment. However, there is a marked probability that, with the present state of Hungarian firms, such a package is enough only for halting the depression, or starting a half-hearted, short-winded expansion.

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FOREIGN DIRECT INVESTMENT AND THE RECONSTRUCTION OF THE ECONOMIES OF CENTRAL EUROPE

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The transformation process in the post-socialist countries in East Central Europe requires not only numerous institutional changes but also fundamental structural changes. Nearly all economic branches have to be modernized and their production profile has to be changed. The consequence is a high demand for capital to finance the necessary investments which cannot be raised in these countries and which have to be supplemented by foreign capital. In this process foreign direct investment will be of great importance.

System transformation and the need for structural change

Since the breakdown of the communist systems in the Central European countries of Hungary, Poland and the Czech Republic[1] (CR) in 1989/90, the political, social and economic changes in those countries have been enormous. Yet, in 1994, they are still far from being finished. Western economists tend to concentrate on the two basic features of the transformation of the economic system: i.e. the privatisation of the state-owned (and cooperative) enterprises, and the substitution of central planning by the market mechanism. Concerning the first point, in general the Central European countries are regarded as having been remarkably successful (albeit with the reservation that there has only been limited success in privatisation of large-scale enterprises). Therefore, most of the economic activity in these countries is still not being carried out by private capital owners. Regarding the second point, the transformation process is judged in a much more negative light. Price decontrol, which with limitations has been introduced almost everywhere, has not led to functioning markets. Monopolistic structures, the persistence of state subsidies for political or social reasons, and the disturbance of the money economy due to excessive budget deficits are seen as the main reasons for this failure.

Often mentioned in professional discussions are the structural disproportions which exist in the three transition countries (as in all former communist countries); although very important, these are not always sufficiently stressed. Changing these disproportions is one of the essentials for the continuation of the transition process. After 1948 the industrialisation in all communist countries was carried out according to the Soviet model. An orientation encompassing interdependence with the world market, which is essential for smaller countries, was generally missing or was

[1] In this paper I have not included an analysis of the Slovak Republic.

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limited to the relations with the other communist countries in the CMEA. The singular concentration on the quantitative growth of production worsened the quality and the technical standards of production. Furthermore, the structure and scale of companies in the Central European countries was distorted due to the Soviet impact. The preference for large-scale enterprises led to monopolistic structures.

In my opinion it is evident that these structural distortions have been—and, indeed, are—decisive obstacles in the way of the transition process. In order to change the economic system it is not sufficient simply to create the legal framework and then expect everything else to follow automatically. It makes little difference whether individual persons or the state are owners of such enterprises if the latter are materially and technically obsolete, or if there are no market opportunities for their oversized capacities (especially since the breakdown of the CMEA-market). Apart from a few modern and productive large-scale enterprises, the privatisation of other enterprises of this type has turned out to be impossible. The best thing would be for the state to liquidate them. Yet, up to now, the state has allowed these enterprises to continue, with the corresponding losses associated with subsidies directed towards them. The reasons for this are primarily political and social.

The possibilities for structural changes

Although the structural changes described are vital for the transition process, it is clear that they are not easy to implement. The most important prerequisite is investment, so that the standard of quality of the existing enterprises can be improved. Parts of the existing plants can be used in different ways, but very often the existing enterprise needs to be replaced by a completely new plant, especially if the production profile has to be changed. Only the real estate, parts of the existing infrastructure (railroad sidings and port facilities, electric energy supply etc.), and some sections of the workforce are available as contributions to capital. The investments which are required for a fundamental structural change are—relative to the economic strength of the transition countries—enormous. I do not know the extent to which the state of the economy in the former GDR, especially of the industry, can be compared with the conditions in the three Central European countries being examined here. In Germany the investments which are necessary for the new "Bundesländer" during the period 1991–2000 are estimated at 500 billion DM—i.e. about 4–5 percent of the West German gross national product. (*Informationsdienst*... 1992a) The main problem with the realisation of the necessary structural changes is, therefore, the provision of the investment funds required. This is the only way to realise the modernisation of the industrial structure.

The extensive modernisation of existing plants or the new establishment of modern plants is essential as the material basis for the transition process. This

is the only way in which a higher productivity level can be reached, so that an adequate supply of the domestic market and competitive export commodities can deliver the necessary profit incentives for private entrepreneurial activity.

The re-establishment of the respective economies of the three Central European countries has become essential after the neglect of the last 40 years. This applies not only to industry and infrastructure but also to all other branches of the economy, where the capital requirements are correspondingly high. There are two ways in which this capital can be provided: domestic savings, or the import of foreign capital.

At present and in the near future the opportunities for domestic capital accumulation are not very favourable. Production is falling in many branches and only since 1993 have there been indications of a slight rise. It is doubtful that the large corporate profits needed for investments and for the capital market (which is just emerging) will be available.[2] With the general decrease in real income, savings from the population will hardly be available in any considerable volume for private investments. The shortage of capital from domestic sources is high, and long-term credit financing by the newly created commercial banks will hardly close the existing gap, this because of the enormous capital requirements.

In this situation capital import is of great importance. The possible opportunities for obtaining long-term foreign capital come in various forms. International banks (World Bank, European Investment Bank etc.) grant credits to the governments of the recipient countries for general promotion of their respective economies (especially for infrastructural investments) or for financing single projects (i.e. they do not place direct investments). However, with respect to direct investments, they may be of importance insofar as they give guarantees or take part in financing these investments. (*Gablers* 1984) The subject of this paper concerns foreign private direct investments in the Central European transition countries. Before discussing the importance of foreign private direct investments for the re-establishment of the economy in these countries it is necessary to make a few remarks concerning their character.

Foreign direct investments—chance or risk?

The internationalisation of all economic processes has grown considerably over the last hundred years, and much of the wealth in the industrial nations can be attributed to the intensification of foreign trade and international capital movements. Historically—starting in Great Britain—the industrialisation of Europe, the U.S. and of South America was mainly financed by foreign investments. Apart

[2] During my (admittedly cursory) examination of literature I did not find any references concerning the present profit situation in the Central European countries.

from the establishment of foreign subsidiary plants and participation in existing enterprises, foreign capital reached the recipient countries in the form of foreign loans. In the second half of the 19th century this process was particularly important in the financing of railway construction. (*Wandel* 1978) Today, international capital interrelations in the form of multinational companies ("Multis", multi-corporate enterprises), or of international capital markets, determine international economic relations.

Nevertheless, in the donor countries as well as in the recipient countries, foreign direct investments are not entirely free from controversy. With reference to this, it can be briefly noted that the donor countries seem to take (irrational) pride in their economic power, which allows international extension of their respective economies, the concomitant intensification of their foreign trade, and additional capital and trading profits. Obviously, the donor countries regard all this positively. However, opponents (in the donor countries) of foreign investments are afraid of increased attention being drawn to their own country, the negative influences that may be felt on the domestic labour market[3] and, depending on the political situation in the recipient country, the possibility of loss of the capital abroad by confiscation.

In the capital importing countries additional investments are made possible by foreign capital, and they regard this as a positive factor. Direct investments usually involve a transfer of technical and organizational knowledge, and therefore they are of especially high value. In the Central European countries they are essential for accomplishing the re-establishment of the respective economies.

However, in politics and in public opinion, in many countries (including the Central European countries) there are quite strong reservations against the arbitrary inflow of foreign capital. There is an irrational fear of "foreign control of the national economy" as a result of the influence of foreign capital; there is also anxiety concerning the "exploitation" or "selling out" of the national economy by foreign countries.[4] More concrete are the fears which are stated with regard to "monopolistic capitalism"; such fears relate to the economic power of international firms, which are seen as having the chance to implement restrictive practices, or political influence which could infringe the political sovereignty of a recipient country. In some ways, these thoughts constitute the content of a "theory of imperialism". In a paper of this scope it is impossible to judge the extent to which these opinions, (which were official ideology in Central Europe for forty years) still exist today; certainly, it is difficult to provide reasons for the particularly strong reservations against foreign investments. For a more balanced estimation of capital imports it

[3] Comprehensive details can be found in *Preiser* (1971).

[4] In the Federal Republic of Germany the same opinion existed in the '50s and '60s with regard to U.S. investments, and in the 70s against the capital-seeking oil money from the Arabian-Iranian countries.

would probably be better to examine the capital interrelations between the Western industrial nations. Over the past 100–150 years capital importing and capital exporting countries have shifted their positions frequently, and increasingly the leading industrial nations hold both positions (i.e. they are both importers and exporters of capital).[5]

Motivations for foreign direct investments in Central Europe

With regard to structural change, the need for general modernisation of production and service installations (together with the limited national capital yield) is the apparent motivation behind the economic activities of Hungary, the Czech Republic and of Poland. The import of foreign capital is almost a guarantee for the necessary re-establishment of a significant part of the national economies of these countries. Direct investments involving private foreign capital—compared to international or governmental foreign credits or borrowing on international capital markets—promise a higher overall economic value because of the private interest of the investors. In discussions concerning the possibilities and readiness of Western investors to place investments in Central and Eastern Europe, the opportunities are sometimes overestimated. Nevertheless, whatever the negative arguments, foreign direct investments appear to be essential for the re-establishment strategy.[6]

The present interest in capital import in Central Europe is overwhelmingly (and obviously) economic. However, in the West the motivation is primarily of a political nature. In the long-term Western capital export should help to overcome the present stagnation as well as the structural drawbacks in the Central European countries, and thus contribute to the social and political stabilisation of these countries. At the same time this means a contribution to the economic transition process which is regarded as vital.

The factors motivating the Western investor to invest in the Central European countries are more complex. The main criterion is evident: the Western investor is going to invest his capital where there is the highest anticipated profit. The income from shares, loans or moneylending competes with the income from the investor's entrepreneurial activity. Of course, the Western investor does not play the part of the coupon-clipping "leisure class".[7] Rather, he provides the entrepreneurial capi-

[5] This holds true especially for the United States, which during the last forty years has changed from being the biggest capital exporter to the most important capital importer. See Wandel (1978, p. 386).

[6] A vehement plea for the commitment of Western capital in Eastern and Central Europe was formulated quite early on in the transition process by Raimund *Dietz* (1990).

[7] Private savings capital, however, is becoming more and more important in the "rich" Western countries; nevertheless its productive investment is mainly carried out with the help of the banking system.

tal which has been formed in the production process. He is either interested in the extension of the business activity of his previous production, or in activity of new production areas. Apart from the estimation of sales possibilities, the comparison of production costs plays an especially important role for entrepreneurial investment decisions. For direct investments from the West into Central and Eastern Europe the lower labour costs (compared with the Western countries) are an obvious incentive. Compared to developing countries, where labour costs may be even more favourable, Central Europe has a relatively highly qualified labour force, the historical-cultural environment is not much different from that of the capital-giving countries and, at least for European investors, the proximity of Central Europe is more favourable with regard to transportation and communication costs.

Also important for the Western investor are the market prospects. The new capacities, which were created in Central Europe with the help of investments from the West, have helped to increase the investor's supply in the Western country of origin or in other locations. This is particularly important if it is possible to satisfy demand with existing plants, or if the new capacities in Central Europe are more cost-saving than the extension of plants in the country of origin or in other locations. Of course, the readiness to invest depends on the current state of the market, as well as on the investor's business outlook. His investment in a transition country might also be intended for the purpose of using these production facilities for supplying the market of that particular country. Western entrepreneurs rate their sales possibilities regarding various goods in Central Europe very positively. This is because the demand, especially in many parts of the consumer goods sector, had not been satisfied for many years or, if it was, the quality was inferior to the Western brand. Thus the Western brand (which was often delivered by a potential investor) usually had a high prestige, regardless of its genuine quality. Western investors are often very enthusiastic about the new, seemingly inexhaustible markets in the East (although this belief is mainly in connection with the "big" markets of Russia and China). Related to this belief is frequently the hope that cheap raw materials can be won. It depends on the size of the Western investor, whether he sees the relatively small Central European countries as attractive markets. With regard to the limited purchasing power of these latter countries, these expectations on the part of the Western investor are usually related to a more distant future. The prospect of supplying other transition countries from a new production facility might also influence the decision to invest or not to invest.

The legal framework for foreign direct investment

Foreign direct investments are a very new phenomenon for the Central European transition countries. Experiences in this field date from the period before

the Second World War and are probably old and forgotten; during the communist period foreign investment was not possible for several decades. Only since 1972 in Hungary, and later in Poland and in the CSSR, has foreign financial interest been allowed in the form of minority interest in state enterprises. Although the number of such enterprises in the eighties clearly increased in Poland and Hungary (i.e. under the conditions of the old system), the amount of capital from the West which was transferred in this way was rather small. Either the corresponding enterprises were small or the share in capital from the West was insignificant. (*Foreign direct...* 1990)

The changes in commercial law (which were implemented in 1990/91 in each of the three countries), and the possibilities for establishing private enterprises in the course of privatisation, were the decisive prerequisites for foreign direct investments. The economic legislation in these three countries now complies with West European regulations. This adjustment was also prescribed in the "European agreement" with the European Union. In general, it can be said that foreign investors are allowed to establish any kind of enterprise without a special licensing procedure (*Balzer* 1992) alone or together with national residents.

Important prerequisites for foreign investment from the West are investment guarantees and suitable regulations regarding the repatriation of profits. In all three countries, the national laws and also bilateral agreements provide guarantees for both. Bitter experiences in the past, and the respective balance of payments of the three countries may make a risk surcharge necessary in the investor's account of income earned from his investment.[8]

The tax treatment of an investor's earnings is also important for the Western investors. In the three examined countries foreign enterprises are generally treated like national residents. Only in some economically important spheres are there benefits for large foreign investments. (Balzer 1992, p. 7) Furthermore, there exist double-taxation agreements between the Federal Republic of Germany and the Central European countries, which provide relief for the German investor with respect to taxes.

Altogether, foreign investment from the West enjoys only slight preference in the economic legislation of the three Central European countries, and therefore in economic policy overall. The incentive to invest therefore lies almost exclusively in the earnings expectations.[9]

This is correct with respect to the principles of a market economy. Regarding the existing difficulties (above all, the complaints about the insufficient cooperation

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[8] This applies to all foreign investments and not only to Poland, The CR and Hungary. Expropriations during recent decades, especially in the developing countries, have deterred possible investors. See the statement in Informationsdienst... (1992b).

[9] In Germany, investments in the New Bundesländer are promoted with tax reliefs, favourable credits and with subsidies from the Treuhandanstalt. Yet, until now, these measures have shown only little success.

of the Central European commercial banks regarding credit accommodation and transactions), it depends on the size of the capital gains in other regions—i.e. whether it is sufficient enough to attract foreign direct investments on a larger scale.

Economic and political conditions for foreign direct investments

On the whole, foreign investments are very sensitive assets. As they are intended as long-term investments, expectations play an important role in the decision to invest abroad. Economically, the investor will regard the possibilities of overcoming the existing stagnation and the chances for economic recovery as conditions for his investments. In this respect, at the present time the Czech Republic has the best image in the West.

Also necessary for a positive decision on the part of the investor is the expectation, or even the conviction, that the economic policies of the countries in question will continue the adopted way chosen towards system transition, without the fear of any restriction. This is the only real guarantee for foreign investments. Laws concerning investment guaranty are, even if they are fulfilled according to their terms, of little value because of the problems of valuation.

At present, a deterrent example of unpredictable reform development is the Russian Federation. In the three Central European countries, the aims of transition seem to be evident, although there are differences with respect to their implementation. Therefore the cautious foreign investor will also take a look at specific parts of the respective economic policies. Money policy and anti-inflation policy, the national budget and its subvention policy, as well as the state's treatment of the money market, balance of payments and exchange-rate policy all contain problems which are of great importance for any kind of foreign investment decision.

Apart from the economic and economic policy environment, the political domestic situation and the foreign policy orientation of the recepient countries is very important. Regarding the three examined countries, their foreign orientation towards membership of the European Union and of NATO may seem a sound basis for foreign investors. With respect to internal politics, the dangers of splintered parties, parliaments, minority governments and extreme political groups have not yet been nullified completely. Such dangers are bad conditions for a positive development of foreign investments.

Foreign investments presume the confidence of the investors in the location of the investment. In the Central European countries foreign capital is required on a large scale for the global re-establishment of the respective economies. The governments of these countries can make their contribution to this necessary confidence—forming process by practising a stability-oriented development policy, in which the parties involved pursue goals which have the qualities for consensus-building.

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SYSTEMIC CHANGES IN THE CZECH ECONOMY AFTER FOUR YEARS (1990-1993)

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The discussion is based on the thesis that the main open issues of the current stage of systemic changes are based so far on a weak microeconomic foundation of macroeconomic stability. The discussion of "shock vs. gradualist" strategies is a misleading road towards the explanation of the causes of transformation recession. The core of growth renewal is based in the microsphere, well-defined property rights and efficient corporate governance which is still in an embryonic stage and hindered by a modified paternalism and slow restructuring. Some significant changes were achieved in the reorientation of foreign trade relations.

The performance of the domestic and foreign sectors of the Czech economy in the process of transition has been, and continues to be, based upon institutional changes, the microeconomic foundation of macrostability, and flexible adjustment to the external environment.

Relations between microeconomic and macroeconomic aspects of an economy in transition are usually subject to changes. In the Czech economy a macroeconomic policy leading to stability has been the pre-condition for microeconomic changes in the price relations, especially in the starting phase of transition. At the same time, during the phase of institutional and ownership changes, the maintenance of macroeconomic stability has depended on the effectiveness of microeconomic changes.

In this contribution I start with the assumption that the main issues in the current phase of systemic transition and recovery of the Czech economy centre upon the so far weak microeconomic foundations of macroeconomic stability.

Misleading explanations concerning recession in the transition

Among Czech economists the discussion concerning shock vs. gradualist strategies is still an ongoing feature. However, it seems that four years in the process of transition enables previous hypotheses and statements to be compared and contrasted on the basis of empiric data. Thus it is possible to clarify the answers to some questions, as well as ending those debates which no longer have a useful purpose.

Several Czech economists consider the significant decrease of GDP and industrial production to be a direct result of so-called "shock therapy". Yet unfortunately, most authors do not work with any precise specifications and definitions of

the respective shock and gradualist strategies. If shock strategy, in its broad outlines, is regarded as a fast price liberalization and mass devaluation of the currency, then it is quite clear that the procedures chosen in the liberalisation phase of transformation in Czechoslovakia and Hungary were significantly different, particularly from the viewpoint of the speed at which the changes applied were implemented.

However, medium-term statistical data do not prove the assumed direct connection between the speed of price liberalization and, on the one hand, the point at which the real exchange rate is reached and, on the other hand, the decrease of economic activity.

In spite of different approaches in initiating liberalization, the fall in industrial production in the Czechoslovak and Hungarian economies has been approximately the same. In comparison with the year 1985, industrial production at the end of 1992 in Czechoslovakia reached 67.8 percent and in Hungary 65.0 percent. (*Bulletin* 1992)

The continuing discussion about the decrease of the output due to shock therapy does not really contribute to a useful critical analysis of stabilization policies, nor does it throw much light on the causes of recession related to transition. In addition, it does not lead to any productive normative conclusions with regard to the conditions necessary for the restoration of the economic growth.

Where to look for the causes of economic decrease

The causes of the unexpectedly deep and relatively long decline of economic activities in the transition economies are still a subject of many professional discussions. Opinions on this subject are highly diverse, and a valid consensus leading to an explanation of this "puzzle" (Richard Portes) has not been reached yet. Shocks of an external or internal character do not lead to a sufficient and satisfactory analysis of the causes of the recession in the respective transition economies (although this does not include those causes which have their origin in the cyclic development of a normal market economy).

It needs to be noted that a decrease in output continued after the relatively fast territorial change in foreign trade, and the nearly total replacement of lost markets after the collapse of the CMEA markets. In the Czech economy there has also been a one-year experience with the renewal of growth of aggregate macroeconomic demand. This was recommended by some Czech as well as foreign economists as the main direction for promoting growth policies and the exploitation of potential product. However, in 1993 the growth of household demand did not suggest that this had any significant influence on the production revival. Evidently it is a case of a negative income elasticity. Higher consumption was mainly satisfied by the

increase of imports. A similar phenomenon can be seen in the revival of demand for investments.

The often recommended strategy of allowing a slight deficit budget policy would not, under given conditions, ensure the recovery of the economic growth. Moreover, it would cause a relative decrease in the already limited credit sources available for development of the private sector. In fact, deficit financing could generate an acceleration of inflationary pressure. Control of inflation remains the first priority of macroeconomic policies, even though a widening of economic priorities in the interest of supporting growth factors would be useful and desirable.

Current conventional quantitative macroeconomic analyses of the problem of recession in the transition are not satisfactory, and those recommendations that involve expansive macroeconomic policies are not convincing.

In my opinion, the main problem in the current phase of systemic transition is represented primarily by the, so far, weak microeconomic foundation of macroeconomic stability. Under current circumstances we are facing a problem about how to maintain relatively good results for current stabilization policies.

Usual quantitative analysis does not give any sufficient explanation of the factors which cause the decline of economic activities. These factors are most probably deeply rooted in the microsphere, and involve the heterogeneous, antagonistic and divergent patterns of behaviour on the part of the participants in the process of transformation. The key problem of a growth-oriented economy in transition is not the expansion of aggregate macroeconomic demand in order to revive potential product. I think that growth renewal and system change centre upon the need to strengthen the supply factors. The latter involve the microsphere, well-defined property rights, efficient ownership structure and motivation structures.

In other words, the chosen privatization programme actually enabled a relatively fast transfer of a significant number of state companies to new owners. However, their influence on the change of the behaviour of economic actors has so far been weak. We lack an efficient system of corporate governance, and yet this can only be developed in an evolutionary way.

Corporate governance—the Achilles' Heel of the current phase of the systemic transition

The efficiency of companies in market economies is conditional upon efficient corporate control; in Anglo-American theory and practice this is called "corporate governance". It is not an accident that the Czech language, so far, does not have any equivalent for this expression.

The expression "corporate governance" usually refers to the institutional and instrumental way by which a company is controlled by its owners. It is a question

of the choices the authorities of the company make with regard to the management structure, the methods adopted for the performance of managers, the ways to motivate managers, and the statutory structure of the authorities in the decision-making processes. In other words, it is a question of the means by which the owners of the company carry out the process of management and control in their own interest.

The way in which property rights are interpreted has a crucial effect on the competitiveness and prosperity of the company. This is why experts pay considerable attention to the character of the very different types of corporate governance in, respectively, German, American, British and Japanese industry.

The conditions for the evolutionary development of efficient corporate governance in the process of systemic change are without precedent; this is why the experiences encountered so far allow no more than a preliminary and approximate evaluation of the salient issues.

In 1990, the highly centralized management and precise specification of planned tasks, as well as the nomenclature appointment of management and their control based on the fulfilment of planned targets, was immediately (and without any protest) abandoned. There then followed an institutional vacuum, and this also accompanied the preparation and realization of the first wave of privatisation. The so-called "founders"—i.e. the establishing state authorities—gave up control over property rights, managers, and the regulation of the conditions of their behaviour. This is how, for example, there arose a situation in which the managers of companies were proposing and in fact also approving management agreements. This resulted in the absence of efficient company control and there appeared sufficient space for various forms of moral hazard—i.e. space for activities which brought some managers one-sided advantages, without them having to bear the burden of costs.

The reaction to the restrictive policy frequently involved a weakening of financial discipline and a strong increase in enforced inter-firms credits. The inability to pay quickly spread to a significant number of companies. This "cancer" of the financial sector even endangered the liquidity of good companies and private entrepreneurs.

Modified paternalism

In the financial sector there is also evidence of some other unfavourable phenomena. The end of state paternalism was indicated by a significant limitation of state subsidies and re-distribution processes. However, it appears that this paternalism has managed to survive, albeit in new modified forms. This is especially true with regard to the relations between companies and commercial banks. Instead of a more determined restructuring, along with all its pains and problems, there is

clearly formal and informal pressure being placed upon commercial banks and state authorities by enterprise managers. These take the form of applications for new credits. The former negotiations for state subsidies and planned tasks have been replaced by intensive negotiations concerning credits; the aim in obtaining these is to overcome the problem of liquidity. These negotiations are very often successful. However, the granting of new credits to "lame duck" companies merely delays the adjustment processes and the rational re-allocation of capital. The postponement (twice) of the Bankruptcy Law as well as its reluctant application has impeded exit from the market of the permanently non-prosperous companies. Thus the new credits they attain soon become and result in slowing down of the re-allocation of credits in favour of the private sector.

This modified form of paternalism has its roots in the weakness of the relatively young commercial banking sector. A high portion of bad credits in the credit portfolio of commercial banks—which has been inherited from former credit regime, but includes new bad credits as well—is not covered by a sufficient level of reserve funds on the part of the commercial banks. This is why the banks are reluctant to start bankruptcy proceedings and they seldom embark on such a course. Capitalization of bad credits in only a compensatory solution and an emergency way out.

A more determined approach to financial restructuring—and thus also to the overall process of restructuring—remains an open problem, even after the end of the first wave of privatisation. The weak points of the financial market negatively influence the gradual formation of the corporate governance of privatized companies in new institutional conditions. By autumn 1993, in the Czech economy, 37 percent of the companies had been privatized partially or totally by the voucher method. The statistical share of the private sector in the GDP has increased significantly to 57 percent. Yet this figure has to be considered carefully. The problem is that the relatively rapid process of privatisation using non-standard procedures still includes, within itself, strong state participation. The latter is in the form of shares in some companies, these shares still being in the hands of the National Property Fund. The whole process of real privatisation will be gradually accompanied by the evolutionary development of new ownership structures, and by searching for efficient forms of corporate governance. It is the character of new ownership structures and the efficient performance of the property rights which will be the final and crucial test for a more complex evaluation of the chosen privatisation scheme.

The feared dispersion of ownership of shares from the voucher method of privatisation has not appeared. On the contrary, new institutional forms of management of the privatized companies have been formed in conditions involving a significant concentration of shares in the hands of the strongest investment funds. Approximately 14 of the strongest investment funds own 70–80 percent of the shares of all investment funds from the first wave of voucher privatisation—i.e. approximately 26 percent of the total assets of the companies privatized in the first wave.

The combined portfolio of the biggest investment funds includes the shares of several hundred privatized companies, while the law limits the share of each investment fund to twenty percent in anyone company. The export portfolio of the investment funds of the two strongest banks comprises the shares of 262 and 514 companies respectively. With such a large number of companies these investment funds will naturally face the problem of participation in the efficient performance of property rights. Investment funds which have a background involving commercial banks cannot possibly have any big interest in finding a radical solution to the problem of financial liquidity and the restructuring of the formerly state-owned companies. However, it is exactly the new owners who are expected to speed up the process of restructuring; so far this has been the weak point in the process of transition. Possibly all privatisation funds and participants in the long-term evolution development of the market order will face similar problems.

The main trends of foreign trade relations of the Czech Republic

The systemic changes of the Czech economy are distinctly reflected in the significant adjustments that have occurred in the fundamental reorientation of foreign trade relations.

Before 1989 the trends in foreign trade, from the point of territorial areas, had been relatively stable for decades. The former Czechoslovak economy was predominantly oriented towards the former CMEA, and this represented almost three-quarters of foreign trade. Within the transition of the Czech economy dramatic changes have been taking place in the territorial structure of Czech foreign trade. The ability to respond to the new external conditions has been fairly high. After four years of systemic change, the Czech Republic's largest trade partners are the European countries, ten of which accounted for a total of more than three-quarters of Czech exports as well as imports. In 1992 the share of developed market economies in the whole of Czech exports reached 67.3 percent (including a 52.8 percent share of the EU countries) and 69.6 percent of all Czech imports (including a 47.3 percent share of the EU countries). Convertible currency export grew very quickly, by 39 percent in 1991 and by 35 percent in 1992. Total exports, however, increased by only 7 percent, due to the decrease of non-convertible exports. Yet, taken as a whole, even the impressive territorial adjustments were still insufficient to compensate fully for the loss on the markets of the former CMEA. The latter represented approximately 3.8 billion USD. Due to this loss, Czech exports in 1992 were still lower by 17.4 percent (in physical terms) than in 1989. Anyway, at least the performance of foreign trade was better than the general picture of the economy. For example, the output performance of the Czech economy was still stagnating in 1993.

The GDP for 1991, as a constant process, was lower by 14.2 percent than in 1990; it was lower by 6.6 percent than in 1991; and in 1993 it was lower by 0.3 than in 1992. The annual decline in industrial production was 22.3 in 1991, 10.6 percent in 1992 and 5.3 percent in 1993.

In 1993 there was an unexpected continuation of fairly good exports, and a slow-down in the former dynamic movement of imports in 1992. In 1993 exports reached 12.8 billion USD and imports 12.5 billion USD. The current account of the balance of payments in convertible currencies in 1993 was even better; this was due to a traditionally positive surplus of the balance services and transfers (which offset deficits from the balance of trade even in 1992).

In 1993 foreign trade increased, especially with the FRG, Great Britain, USA and Austria. This was despite the world recession and the stagnation of GDP and the industrial output of the Czech economy. As a whole, the growth rate of exports in 1993 increased by 20 percent, due to exports to advanced countries (the index for 1993/1992 was 124 percent). This was particularly due to exports to EU countries and the resumption of the trade volume with China and the extension of contracts with South East Asia countries.

One of the negative consequences of the split of the former Czechoslovak federation was a significant decline in foreign trade with the Slovak Republic; this decreased by at least 20 percent.

In 1993 the commodity structure of exports showed a slight progressive growth in machinery production and factory equipment. The export of machines and machinery equipment increased by one-third and accounted for 28 percent of all exports in 1993. However, the share in the export total of semi-processed goods (cement, steel, building materials) continues to be high.

In 1993 some changes were taking place in the volume and structure of the inflow of foreign capital. The net inflow of foreign capital in comparison with 1992 increased and reached 2.5 billion USD.

In 1993 foreign direct investment reached only 0.6 billion USD, which is only one half of FDI in 1992, and 27 percent of all FDI since the beginning of 1990. The main stream of foreign capital inflow in 1993 comprised portfolio investments (1.1 billion USD) and the foreign credits of foreign financial institutions to Czech companies (1.1 billion USD).

The fairly satisfactory performance of the Czech foreign sector was due to a lasting positive impact on exports of a very massive devaluation of the koruna in 1990, as well as the low level of Czech wages. The average monthly wage in dollar terms in 1992 was 169 USD, compared with 280 USD in Hungary and 188 USD in Poland.

In order to bring about a faster recovery of the Czech economy, and more permanent competitiveness, it is necessary for policy-makers to take some determined and bold decisions; this refers specifically to the field of export promotion policies,

more favourable trade agreements with the EU, and a significant improvement of the potential opportunities inside CEFTA countries.

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INDEPENDENT SLOVAKIA AND ITS INVOLVEMENT WITH EUROPEAN ECONOMIC STRUCTURES

L. ANDRÁŠIK-R. OUTRATA

The study deals with the Slovak economy after the dissolution of the CSFR and shows the first period of independence and the main macroeconomic data. It acquaints with the common and different features of development of the V4+S countries. The foreign economic policy, the place and role of Slovakia till the end of the nineties are also shown.

The aim of the first topic in this paper is to present general information about independent Slovakia (SR) and the difficulties it faces in seeking integration with European economic structures.

This first section concentrates on three issues:

— first, there is an overview of the changes that have taken place in Slovakia since the dissolution of the federal state and the first year of independence;

— second, it deals with the external trade development of the SR as an independent state and

— third, it looks at several of the open problems which are currently affecting the external economic relations of the new state.

Every country of the Visegrád Four (V4) and Slovenia are facing several common features of development on the way to integration with European structures, as well as some different ones. In the case of Slovakia there are some additional problems which are unique to Slovakia. The latter are mainly connected with more than seventy years of mutual development in the unitary state of Czechoslovakia, and then with the rapidity with which that state was split up.

The "first" year of the economy in independent Slovakia

Last year was the first step in the existence of the independent Slovak Republic. It is important to say that even when the split occurred last year (1993), when the political activity attracted possibly excessive attention, there was a willingness in Slovakia to continue with the transition process. However, the differences between the Czech and Slovak economies were so significant that, after the split, they immediately caused some deviations from the original transition process. This is why various problems and complexities have appeared in the transition process of the economy of independent Slovakia. Nevertheless, no political formation has seen this as a reason to stop it.

Akadémiai Kiadó, Budapest

Nowadays there are many vital tasks that have to be dealt with in the transition process. In discussions, significant attention has been paid to the problems of privatization, the adaptation of enterprises to a market economy, the conditions and structural aspects of present difficulties, and also the possibilities for development in the future. At the centre of attention there are, as might be expected, external economic relations and the aim to involve Slovakia and its economy more and more in complex European structures. However, this involvement is not only from the point of view of political and economic life. For the new state it is especially important to be accepted as a full member of the European Council, and to sign the Agreement on joining to the European Union.

It is important too, that in Slovakia it has been possible to maintain the pace of price liberalization, economic relations (including the liberalization of foreign trade), and the internal convertibility of the new currency connected with it.

The intervention of the state into the economy has not exceeded those rates and forms which can be considered compatible with the functioning of a transition economy.

In the privatization concept the government, headed at first by Prime Minister Mečiar, has put greater emphasis on its standard methods—especially on direct selling. One can expect that the new government, headed by Prime Minister Moravčík, will pay more attention to the original privatization methods used in the joint Czechoslovak state. Mr. Janičina, the new head of the Ministry of Privatization, has said that his team is now working on the concept of the second wave of "voucher—i.e. DIK paper owners—privatization". The former government had already selected several enterprises to the value of 60–70 billion Slovak Korona (SK). These enterprises were considered "ideal" for the purpose. The minister said the new government ought to devote 100 bln Sk towards this up to this summer. The "return" to this policy is very interesting because experience shows that paper owners do not and cannot behave in any other way than ordinary bondholders. To expect such people to provide that kind of spirit of ownership which is the energy that drives companies forward is unrealistic. This method only helps to create one form of private ownership. Yet the real question is: will this method really be capable of bringing about the natural private spirit of ownership which is such a necessary driving force? The reality in Slovakia appears to suggest this is not happening. These paperholders have not cast their lives and fortunes with the companies. At present, some of them are selling their papers at very low prices. It is not certain whether the new holders will prove to be the right owners, the true managers, the entrepreneurs who can "turn things around". This is the main question at present and for the near future as well. In Slovakia, we can see that the process of encouraging real entrepreneurship is very slow and painful.

Everyday discussions are narrowly connected with the tasks of macroeconomic regulation: i.e. maintaining the external and also internal balances, or limiting the influences which disturb these balances.

The Slovak economy as a whole

The development of the economy in the first year of independence was influenced by the division of the former federal state. It was also affected by tax reform and by recession in the developed economies.

The drop in efficiency was manifested immediately in the first months of the "starting" year. However, this one was mitigated slightly in the course of the year. The GDP dropped against 1992 by about 7 percent. The break in development was reflected in the industrial production too. In 1993 the decreases in the individual quarters of the year in comparison with the same period of the previous year, permanently indicated a worsening situation. In contrast to the previous years this drop was caused by the fall in external demand (both from the Czech Republic and also from other countries); it was only partly due to the restriction of domestic demand. The export ratio on the sale of the industrial production remained significantly high in all branches of the processing industry (with the exception of the food industry). After the former interior supplier relations with the Czech Republic had changed to foreign trade relations, Slovak industry became extraordinarily sensitive to the development of conjunctural situations, especially in neighbouring countries and in Germany.

Industrial production

The drop in industrial production has resulted in only a partial drop in employment; in a majority of branches it has led to a remarkable decrease in labour productivity; in 1993 it dropped by an average of 8 percent. The most negative development in labour productivity has appeared in those branches where breaks in production have been accompanied by price increases (e.g. in food processing and crude oil refinery).

In the structural development of industry there is still a tendency to strengthen production at a lower stage of processing with higher demands being placed on energy and material resources. It is manifested in the respective ratios of decrease in the mining, energy and processing branches, as well as in chemical and metal production, engineering, and further branches dealing with finishing processes.

A common illness—insolvency and deficits

As a consequence of decreased possibilities for sales in 1993, the economic situation of enterprises was further complicated. Many enterprises faced deficits or insolvency. Thus enterprises have to pay special attention to maintain a balance in a very uncertain and irrational environment.

A certain shift has occurred with the increase in the number of small and medium enterprises involved in industrial production.

Very unfavourable developments have also been felt in the construction industry. More than one-quarter of the fall in its output is connected with the total recession. This has led to a decrease in investment demand, both in the enterprise sphere and in the budget sphere.

In contrast to what has been said above, the developments in agriculture in 1993 were remarkable, due to the effect of certain stabilizing elements.

Labour market and unemployment

Developments in the labour market in 1993 were influenced, as might have been expected, primarily by the recession of the economy. By the end of 1993, in comparison with 1992, the number of workers in industry was lower by 11 percent, in construction works by 16 percent, while in trade it was higher by 22 percent. In the same period the number of workers employed in the private sector increased in industry by 49 percent, but in construction it decreased by 11 percent. Nowadays unemployment in Slovakia exists in two forms. The first form is accounted for by reported unemployment. The second form is latent—i.e. it refers to the unemployment in the state enterprises, and—albeit with a certain decreasing intensity—also in the stock companies which emerged from previous state enterprises and have now been privatized.

The basic trends of development in the Slovak national economy at the beginning of 1994 (comparison of January 1994 with January 1993)

— consumer prices of goods and services increased in total by 16.4 percent,

— cost of living increased by 16.3 percent,

— total registered number of unemployed at the end of January 1994 was 379,170, a figure 11,075 greater than in December 1993. In January the newly-registered unemployed totalled 33,373 persons; the registered unemployment rate reached 14.9 percent,

— number of private entrepreneurs not listed in the "Business Register" was 283,272,

— recognized private firms increased by 442 and reached a total of 26,156—this is 90.3 percent of the total number of recognized enterprise organizations—i.e. private + state = 28,972 enterprises.

External trade development of Slovakia as an independent republic

The transition has given Slovakia the opportunity to operate a much more open economy than before.

Not only external factors, but also internal ones have played, and continue to play, an important role in Slovak external trade development. One of the most important internal factors which has affected the competitiveness of Slovak industry has been the process of enterprise privatization and restructuring.

At the end of 1992 Slovakia's share of the former Czechoslovak foreign trade turnover was 31 percent. Exports to the market economies represented 29 percent of the Czechoslovak total, and to non-market economies 39 percent. The figures for imports were 26 percent and 40 percent respectively.

The situation before "splitting" is depicted in *Table 1*.

Table 1

Development of the export territorial structure of the SR (in percent, US$)

	Export				Import			
	1989	1990	1991	1992	1989	1990	1991	1992
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
in that:								
USA	0.6	0.8	0.8	1.3	1.9	1.3	1.1	1.6
Japan	0.3	0.5	0.2	0.3	0.8	0.7	0.6	0.9
EC	18.4	28.2	35.1	41.6	22.3	26.8	24.6	34.2
EFTA	8.1	9.6	8.0	10.5	9.6	16.8	11.3	13.8
former CMEA	57.2	37.6	41.4	29.7	49.7	39.0	52.4	42.5
Rest of the world	15.4	23.3	14.3	16.6	15.7	15.4	10.0	7.0

Source: Statistics of VUVEV, Prague, 1993.

Territorial structure

Table 2 shows the prevailing tendency of a greater decline in exports than imports.

In the general decline of Slovak turnover, the development has been different to that of the Czech Republic and the other countries. While the turnover towards the Czech Republic declined in 1993, the one towards other countries has grown. A total overview of the turnover dynamic across relevant territories/organizations is provided in *Table 3*.

Throughout 1993 Slovak foreign trade and the trade balance itself were very unstable, especially in the last months of the year. The total trade balance of the SR in the first half of 1993 showed a deficit of billion Sk. In the second half this

Table 2

Development of foreign trade of the SR (including CR) (current prices)

		1991[1]	1992[1]	1993[2]	Index 92/91	Index 93/92
Total turnover	bln Sk	419.1	388.4	361.1	92.7	93.0
	bln US $	14.2	13.7	12.1	96.5	88.1
Export	bln Sk	199.7	184.1	167.2	92.2	90.8
	bln US $	6.8	6.5	5.6	95.6	85.9
Import	bln Sk	219.4	204.3	193.9	93.1	94.9
	bln US $	7.4	7.2	6.5	97.3	90.0
Balance	bln Sk	-19.4	-20.4	-26.7	–	–
	bln US $	-0.6	-0.7	-0.9	–	–

[1] *Source*: Statistics of VUVEV, Prague, 1993, and estimates of Federal Statistical Office, Prague.
[2] *Source*: Corrected estimations, Central Custom Office of the SR, Bratislava, February 1994.

Table 3

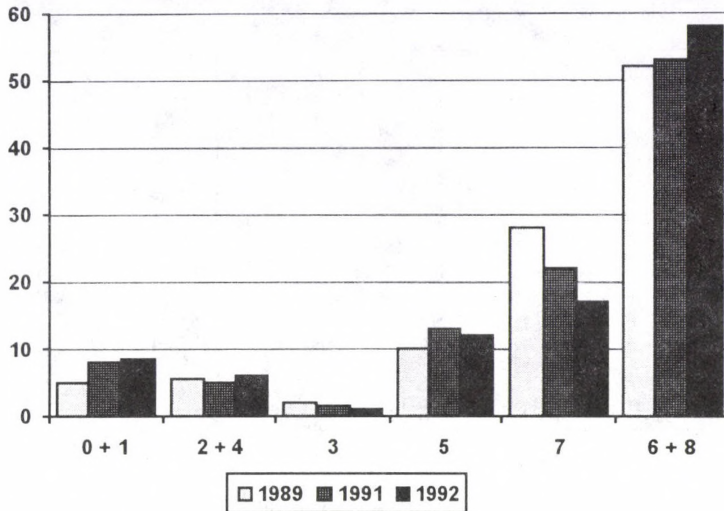
Turnover development by territories/organizations

	1992	1993	Index
Turnover bln Sk	388.4	361.1	93.0
of which:			
CR	189.1	138.8	73.4
other countries	199.3	222.3	111.5
of which:			
EU	75.5	81.1	107.4
EFTA	24.2	28.1	116.1
CEFTA (inc. CR)	206.0	157.9	76.7
Former CMEA (without CEFTA)	54.7	60.0	109.7

Source: *Year 1992—Computer survey of the Institute for External Economic Relations*, Prague 1993, and *The estimation of the Federal Statistical Office concerning Slovak trade with the CR*; *Year 1993—Preliminary revision January—December 1993, Central Custom Office of the SR*, Bratislava, February 1994.

deficit had reached 20 bln Sk, especially towards other countries. The trade balance with the CR in 1993 was relatively stable.

The increase of the trade deficit, especially in the last quarter of 1993, was mainly due to the falling off of trade with the territory of the former Soviet Union. The overview of the foreign trade commodity structure can be presented in diagram form.



Legend to *Figures 1* and *2*: (SICT classification, rev. 3)
0 + 1 – food and live animals, beverages and tobacco
2 + 4 – crude materials
3 – fuels and related products
5 – chemicals and related products
7 – machinery and transport equipment
6 + 8 – intermediate manufactured products and miscellaneous manufactured articles

Fig. 1 Export commodity structure (in percent)

The trade commodity structure tendencies during the period 1990–92 also survived into 1993. In exports, the share of products with a lower rate of manufacturing has been maintained at a relatively high level, while the export of machines and foodstuffs has decreased. Imports, especially in 6 and 8 of the SITC classification commodity groups (miscellaneous manufactured articles), has declined mainly because of the decline of industrial output.

Customs union with the Czech Republic and the payment agreement

The institution of a customs union was considered as an element which would help to maintain the previous level of trade relations. To sustain trade relations between Slovakia and the Czech Republic, a positive role could be played by a payment agreement based on a clearing payment mechanism. There would be some advantages with this, such as speeding up the process of payment operations and lowering costs. Marginal credit provides a support for export expansion. At present, the last mentioned advantage is more exploited by the Czech Republic.

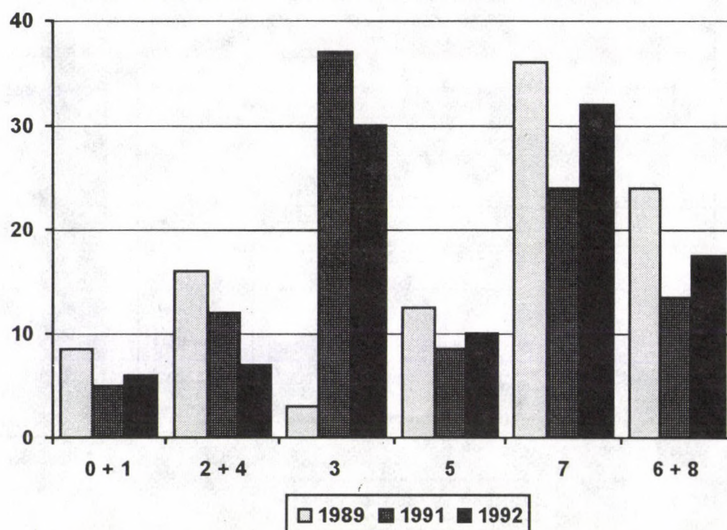


Fig. 2 Import commodity structure (in percent)

This fact has some negative features for the Slovak Republic and puts pressure on hard currency reserves.

It seems that the key issue here is the need to set the proper level of marginal credit. This should be done by taking into account some objective factors regarding the Slovak economy's lower level of export performance.

The devaluation in summer, 1993

The devaluation which occurred in summer 1993 was another policy measure introduced with the aim of stabilizing the level of trade with the Czech Republic. Nevertheless, the main reason for devaluation was the state of the Slovak National Bank's hard currency reserves; the latter decreased by an amount equal to the total Slovak trade deficit, although it was not the same as the trade balance with the CR which, in the first half of 1993, was moderately in the surplus. At present it is possible to conclude that the devaluation was not sufficient to affect trade with the Czech Republic.

Despite the fact that a detailed analysis is needed in order to be able to evaluate the impact of the devaluation, the question here is whether Slovak exports are sufficiently price elastic, and whether another (higher) devaluation would do no more than cause a further decline of foreign currency assets.

Some concluding theses

In order to improve trade patterns between the Slovak Republic and the Czech Republic, it is inevitable that industry is restructured; however, this will be the result of a long-term process. In the first year of independence of the Slovak Republic, the balance of foreign international trade worsened, especially in relation to well-developed market economies.

The imports increased and the exports decreased. The influence of devaluation on this negative development was weak and was unable to stop it.

A smooth export-supporting effect was achieved, but the prices of inputs increased. The real terms of trade worsened.

In general, even after the optimism following the change of government, the real problems facing the new state do not give cause for much optimism in confronting the challenges of the future.

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REVIEWS

THE TRANSITION IN AGRICULTURE

I. FERTŐ

Towards the end of the 1980s agriculture in Hungary began to fall into an increasingly deep crisis. After the political changes this process accelerated. Between 1986–1992 peculiar contradictions characterized the agricultural sector: declining production and increasing exports, shortages of goods and oversupply. However, the changing price conditions, the development of budgetary relations, the collapse of the eastern markets and the uncertainties due to the changes of ownership do not fully explain the nature of the crisis. The roots of the troubles can be found in the past, especially with reference to the insufficient development in the institutional system of the Hungarian "agribusiness". More precisely, the circumstances that have emerged in Hungary illustrate an undeveloped network for producing the input of agriculture, for processing its products, for agricultural marketing and for the services belonging to all these activities.

Hungarian agriculture was considered a success sector of the socialist system. In the eighties in Hungarian professional circles it was an almost unequivocal opinion that Hungarian agriculture had reached the world level, and thus no further reforms were necessary. Nevertheless, the basic problem of agriculture was not the form of organization (ownership) but the extent of collections made by the budget (*Sántha* 1989). This was supported by the facts that Hungarian agriculture provided domestic food supply on a fairly high level (especially compared with the other former socialist countries), exported one-third of its production, from a budgetary aspect was a net payer-in, and its indices of production were on a world level. In the mid-eighties not only the majority of Hungarian researchers but even many foreign analysts were of the opinion that the Hungarian agrarian system was on the right course and could serve as a model for the rest of the countries in the Eastern bloc. (*Hartford* 1985; *Marrese* 1986; *Swain* 1985). There were some, however, who even at that time suggested that the export strategy built on Eastern markets was a mistake (*Lányi* 1984 and 1985). Also, it was pointed out that the practice of

The study serving as the basis of this paper—Egy sikertörténet bukása (A magyar mezőgazdaság, 1986–1992) (The failure of a success story: Hungarian agriculture 1986–1992) was made in the framework of a research project called "Hungary's transition towards a market economy, 1986–1992". The research was carried out under the leadership of János *Kornai*, with the support of the OTKA, the Collegium Budapest, the Institute of Economics of the Hungarian Academy of Sciences, and the Austria Lotto. I wish to use this opportunity to express my gratitude to János Kornai and Kamilla *Lányi* for the valuable remarks that they made on the original version of this paper. The responsibility for the statements made in the paper lies, of course, with the author.

large-scale farming was contrary to the main trend evident in the world's agrarian development (*Kopátsy* 1986). Furthermore, some observers felt that Hungarian agriculture had reached a deadlock (*Juhász* 1988). In the following developments between 1986–1992 will be examined, and the factors of success and crisis will be considered.

Hungarian agriculture in an international comparison

The international comparison of Hungarian agriculture will be made here according to three different aspects. First, there will be an examination of the role agriculture has played in the economies of individual countries. Second, the position of Hungarian agriculture in Europe will be looked at, especially from the aspect of efficiency. Finally, the differences in various agricultural structures will be analysed.

The role of agriculture in the economy

Hungarian agriculture has always had (and still has) a favoured position in the national economy. In 1990 it produced 14 percent of the gross domestic product, employed 17 percent of the active earners, and used about 15 percent of the country's stock of fixed assets. Its share in investments was about 10 percent, it produced 23 percent of the total exports, and it accounted for almost 8 percent of imports. (The proportion of agriculture in the economies of the East-European and of the advanced countries in 1990 is shown in *Table 1*.)

A similarly important part is played by agriculture in other parts of Eastern Europe. Its share in the GDP shows a similar proportion in Bulgaria, it is somewhat higher in Romania and Poland, and it accounts for 8 percent in Czechoslovakia. In Romania and Poland the ratio of the active earners is higher, while in Bulgaria and Czechoslovakia it is lower than it is in Hungary. The share in the imports is higher in Czechoslovakia, Poland and Romania, while in Bulgaria it is approximately the same. The share in exports is lower in every country, but while in the case of Bulgaria and Poland it is 12–15 percent, in Czechoslovakia and Romania it is only 6 and 3 percent, respectively.

In the economies of the advanced countries the role of agriculture is considerably lesser. In the countries outside Europe the share of agriculture in the GDP is half to one-third of that usually found in East Europe (the only exception to this is New-Zealand, where the agrarian economy has, even today, a significant weight.) The share of imports in countries outside Europe shows a dispersion similar to that in East Europe (5–15 percent). In turn, the significance of agriculture is decisive in Australia and New-Zealand (35 and 59 percent, respectively).

Table 1

The proportion of agriculture in the economies of the East European and the advanced countries in 1990 (percent)

Countries	GDP	Active earners	Imports	Exports
Bulgaria*	14.2	14.6	7.0	12.0
Czechoslovakia*	7.8	12.1	12.0	6.0
Poland*	16.2	27.6	13.0	15.0
Hungary	13.9	17.1	7.7	23.1
Romania	16.2	27.5	15.0	3.0
Canada	3.0	4.5	5.6	8.2
United States	2.0	2.9	5.1	13.2
Japan	2.6	7.9	14.6	0.4
Australia	4.2	5.9	4.8	35.1
New Zealand	8.4	10.4	7.9	59.1
EC–12	2.9	7.4	10.9	7.6
Denmark	3.7	5.8	10.1	22.7
France	3.3	6.8	10.5	12.1
Germany	1.6	4.9	10.1	3.3
Greece	14.4	26.6	12.4	22.1
Ireland	9.6	15.4	9.6	22.9
Italy	3.6	9.9	12.3	5.2
The Netherlands	4.0	4.8	16.4	18.2
Spain	5.3	14.4	14.2	14.6
United Kingdom	1.2	2.3	8.0	5.8

*Instead of GDP, net national product. Data for the developing countries refer to 1988.
Sources: *OECD* 1993a; Mezőgazdaság és élelmiszeripar (Agriculture and food industry) 1992. AKII. 1993. *FAO* 1992.

Somewhat different is the position of agriculture in West Europe. Agriculture's proportion in the GDP is, on average in the EEC, only 3 percent (albeit in the background there is a significant dispersion). However, with the exception of Greece, this ratio nowhere exceeds the level of 10 percent. The share of the active earners in agriculture is high in the South European countries and in Ireland. The ratio of imports ranges between 8 and 16 percent, which is similar to the indices of both the East European and the extra-European countries. The share of agriculture in exports is outstanding (more than 20 percent) in Denmark, Greece and Ireland. The other extreme is represented by Germany, Italy and the United Kingdom (3–6 percent).

The weight of Hungarian agriculture in the economy is average for East Europe (with the exception of the significant share in the exports). However, compared with the advanced countries, the role of the agrarian sector is much more important. Its share in the Hungarian GDP is exceeded only in Greece; in all the other countries it is significantly lower. With regard to active earners, Hungary lies close

to the South European countries. In the case of the imports, Hungary belongs to the group of countries having a lower share. The ratio of exports shows that Hungary is similar to that group of West European countries producing significant agrarian exports.

The efficiency of Hungarian agriculture in an international comparison

The competitiveness of Hungarian agriculture is usually measured using quantitative indices. In 1987, with regard to the per capita production of cereals, Hungary was in third place, being behind only Canada and Denmark. Such producers as Australia and the US came after. (In this rank order Romania was closely behind Hungary.) Regarding the per capita meat production, Hungarian agriculture also took an impressive third place. Somewhat worse than these results were the ones shown by cereal production per hectare and by the annual quantity of milk per cow; nevertheless, Hungary was in the upper third in these aspects, too. The indices of fodder utilization were not as auspicious as these, and the domestic indicators exceeded those of the advanced countries by a modest 25–30 percent.

The studies carried out on the basis of indices, which express the efficiency of agrarian production in a complex manner, show a far less favourable picture than the one given above. The Central Statistical Office made comparisons about the efficiency of Hungarian agriculture using four methods (*Németh, Rózsa and Vita* 1986 and *Rózsa and Vita* 1988). In an analysis including 23 European countries, *labour productivity was examined on the basis of FAO's data*. The productivity data were computed on the basis of the value of the so-called "final production of agriculture", expressed in US dollars. The final production of agriculture is the output of agriculture in relation to other sectors. On this basis Hungary was ranked in 15th place. Of the then socialist countries the GDR and Czechoslovakia were immediately ahead of Hungary and the others were behind. Belgium, the Netherlands, and the United Kingdom took the first three places. The *examination of* the *area productivity*, which is calculated by the value of final agricultural production per hectare of ploughed, horticultural, viticultural and orchard land expressed in US dollars, led to similar results, Hungary, even in this competition, finished in 15th place. The results of the countries before and behind Hungary were similar to those gained in the other studies mentioned above.

The *second* examination was made in the so-called *"production indices summarized in corn-units"* for the period between 1983–1985. The corn-unit is an indicator used for summarizing the quantity of the various agricultural products, which expresses the quantity of agricultural production, considering the various cereals as a unit. The quantity of agricultural production summarized in corn-units was compared with the number of active earners in agriculture and with

the agricultural area. On the basis of labour productivity indices obtained in this way, Hungary finished in 12th place, being ahead of Czechoslovakia, Norway and Greece (which, in the preceding examination, were before her). Based on the area productivity indices, Hungary was ranked in 7th place.

The analyses were also made by *methods using several variables*. The main-component analyses were carried out for 7 condition- and 6 result-indices. Taking into account the production conditions, Hungary was ranked in 13th place; with regards the results Hungary was 7th in the rank order. From the socialist countries, in terms of conditions of production, the GDR and Czechoslovakia were ahead of Hungary, but with respect to the results of output, Hungary was in a more favourable position.

Multidimensional scaling is suitable for the treatment of 7 indices. On the basis of results obtained in this way, Hungary was 14th in rank order, which is somewhat better than the comparison made on the basis of FAO indices. Even so, Hungary was placed in the last one-third of the scale (that is, in the field consisting of the European countries).

The efficiency of Hungarian agriculture in the early 1980s was in the middle of a scale consisting of European countries. However, it should be noted that in the top-ranking countries (such as the Netherlands, Belgium-Luxembourg and Denmark) the efficiency of agriculture is three or four times higher than that of Hungary, while in those countries in the last places (Greece, Spain, Portugal) it is two or three times lower than Hungary.

The structure of agriculture

In this section farms will be analysed from two points of view. First, the various types of the farms will be examined, and, second, their sizes will be considered. The various types of the farms will also be distinguished: first from the aspect of ownership of the means of production; second, on the basis of the source of labour; and third, with respect to the source of the incomes. The size of the farms can be measured in several ways. First of all, measurement can be carried out by applying quantitative factors, (area, the number of commercial livestock, labour force); it can also be done according to the value of the employed production factors (value of the farm as a unit, actual capital, the amount of plant inputs); finally, the measurement can be based on the characteristics of yield and profit (plant yield, profit).[1] Since comparable data are only available with reference to the size of the land area, it was this index that was selected for illustrating the size of the farms.

[1] The science of agricultural management deals in detail with the question of farm size and the growth of farm size. From the extremely rich literature reference can be made to the works of *Steinhauser, Langbehn and Peters* (1984, especially pp. 211–235) and *Castle, Becker and Nelson* (1992, pp. 246–267).

Agricultural production is pursued in Hungary in three forms: in state farms, in agricultural cooperatives and in private farms. In 1989 the land area was distributed among the three forms of farms as follows: state farms used 14.9 percent, the cooperatives 70 percent and the private farms altogether 14.2 percent of the land area. The means of production of the large-scale farms were in state-, or, in cooperative ownership (although in the case of the cooperatives one-third of the area they covered could not be counted in this category). The production was pursued by employees or members working full time; they had a wage-workers' relationship with the enterprises. This point is not altered by the fact that the members of the cooperative were formally owners; hence, they had a say in the operation of the farm. Practically, however, the large-scale farms were led by managers. In the private farms the means of production were (and still are) in private ownership; here, in the production process family work is decisive. However, agricultural activities in the private sphere are pursued merely part-time, and the income of the household is not generated solely from agriculture.

In the agriculture of the East European countries—with the exception of Poland—the situation is similar. The dominant forms in these countries are also the state farm and the agricultural cooperative. In Bulgaria and Romania the large-scale farms together possessed 90 percent of the land area in 1989. In Czechoslovakia, in 1989, 30 percent of the land was in the possession of state farms, and approximately 64 percent was possessed by agricultural cooperatives. The decisive part of agricultural production was also done in these countries by the large-scale farms of the state and by the cooperatives. The contribution of the smallholders in Czechoslovakia was 10–12 percent, while in Bulgaria it was round 25 percent. In Poland the attempts at collectivization failed; consequently, the dominance of family farms survived. The private farms were in command of about 78 percent of arable land in 1989. Therefore, in contrast to the other East-European countries, the decisive proportion of agricultural production was pursued in farms based on family labour. Here, too, the weight of farms operated on a part-time basis is significant.

In Western Europe agricultural production in carried out on farms based on private ownership, and no large-scale farms using wage labour—which are so widespread in Eastern Europe—can be found. Land area on lease, on average in the EEC, amounts to about 35 percent, but this value is markedly dispersed among the member countries. (In Ireland it is 4 percent, while in Belgium it is 68 percent.) This is primarily due to historical, legal and traditional factors. The farms are mainly based on family work and the ratio of wage labour is practically negligible: the average in the EEC is a mere 7.7 percent. The share of wage-labour is greatest in the United Kingdom (32.9 percent), and it is also high in the United States (32.4 percent); it is smallest in Greece (0.2 percent). (See *Table 2*) The farms operated on a part-time basis also represent a significant ratio in the agriculture of the advanced countries. According to an assessment for the year

1980, the proportion of farms worked as part-time entities ranged from 22 percent to 91 percent of all farming units. Their share in France was not more than 22 percent, in Ireland it was 42 percent, in the United States 55 percent and in Japan 87 percent (*Elek* 1991).

The farm structure of agriculture, due to the socialist development, became extremely dualistic in Hungary. In 1989 in Hungary there were 1500 large-scale farms, which used 85 percent of the land area. As a result of this, the average size of the area of the large-scale farms was 7600 hectares. These each employed, on average, more than 860 persons. Owing to the auxiliary business branches, the number of those linked to agricultural activities was lower than this. The average area of the 1.4 million private farms was 0.62 of a hectare.

In 1989 in Czechoslovakia the average size of the state farms was 6042 hectares, while that of the cooperatives was 2597 hectares. In Poland, where the significance of the large-scale farms was not so great, their land area amounted, on the average, to 2601 hectares. That of the cooperatives was 310 hectares.

Table 2

Some characteristics of the agricultural structure in the advanced countries in 1987

Country	Average plant size (hectare)	Ratio of land leased (percent)	Source of farm labour family (percent)	wage worker (percent)
United Kingdom	64.4	37.4	67.1	32.9
The Netherlands	15.3	35.5	83.4	16.6
Denmark	32.2	18.3	84.0	16.0
Belgium	14.7	68.4	94.9	5.1
France	28.6	53.3	83.2	16.8
Luxembourg	31.8	48.5	92.9	7.1
Germany	16.8	36.4	93.9	6.1
Ireland	22.6	4.0	90.8	9.2
Italy	5.6	20.0	97.7	2.3
Spain	13.8	30.2	90.3	9.7
Greece	4.0	22.9	99.8	0.2
Portugal	5.2	33.7	92.6	7.4
EC–12	13.4	35.1	92.3	7.7
USA*	183.0	n.a.	67.6	32.4

*1988

Source: EUROSTAT: *Agriculture. Statistical yearbook 1990*. Bruxelles–Luxembourg, 1991. *The agricultural situation in the Community, 1991*. Report. Commissions of the European Communities, Brussels. *Cramer and Jensen* (1991)

The average farm size in the EEC is 13.4 hectares. The greatest average size is that of the United Kingdom, where it is 64.4 hectares. Only in Denmark and

Luxembourg is this average also over 30 hectares. In the South-European countries the average farm size is less than 10 hectares. In the US, in 1988 the average size of farms was 183 hectares. This figure exceeded by far the sizes customary in Europe. It can be added to this that the sales return of 1.3 percent of the farms was more than 500 dollars in 1984, which means that they reached 31.2 percent of the total sales return.

In conclusion it can be said that the farm structure of Hungarian agriculture basically differs from that of the advanced countries. In Hungary there are the large-scale farms managing thousands of hectares, and at the same time there are the typical dwarf farms, utilizing mostly part-time labour. In contrast, in Western Europe, farms are almost exclusively based on family labour, and this is a determinant factor of their character. The average sizes of such farms are far below those of the Hungarian large-scale farms. Moreover, the ratio of the farms worked on a part-time basis is also significant. The farm sizes are lower in the United States, too. Here, the use of wage labour is slightly higher than it is in Europe, and a significant number of farms are also operated on a part-time basis.

Agriculture's performance between 1986–1992

The role of domestic agriculture is still significant in the national economy, though it has gradually been decreasing since 1986. The proportion of agriculture in 1992 fell, such that the number of active earners involved came to 13 percent, agriculture's proportion in the GDP was 11 percent, and in capital investments it was 1.5 percent. At the same time, the ratio of food exports within the total of exports increased, and the decline in the imports was not significant.

In the background of the processes described above a similar change in agricultural production can be found. The volume of agricultural production was—with the exception of 1988—continuously declining. In the two major sectors (plant cultivation and animal husbandry), however, production developed in different ways. After 1988 the proportion of animal breeding strongly diminished, while the performance of plant cultivation fluctuated, depending on the weather conditions. As a result of these factors, the ratio of plant production within the total of the output increased to 53.6 percent.

The number of those employed in agriculture dramatically declined. In 1992 altogether 277.5 thousand people were working in the agricultural sector, which amounts to about 35 percent of the 1986 level. In 1991 the value of investment projects put into operation, after a permanent annual fluctuation, decreased to 65 percent of the level in the previous year. The various inputs after 1988 receded at an accelerated rate. Among these the most significant was the decline of the use of

fertilizers and energy: compared to the figures of 1989, the former fell to one-fifth and the latter to 70 percent of their totals.

The performance of the large-scale farms between 1986–1992

The financial results of the agricultural organizations deteriorated considerably during the analysed period. Parallel with the falling rate of profit, losses grew rapidly, and in 1992 agriculture achieved a deficit of approximately 29 billion forints.

The law on bankruptcy enacted in 1992 made several loss-making large-scale farms confront insoluble tasks. Data of a relatively detailed nature are only available about the cooperatives, so their situation will be presented. One-quarter of the cooperatives had to declare bankruptcy. In 85 farms the liquidation process was started. The ratio of bankruptcy and liquidation proceedings in the agricultural cooperatives reached 26 percent, which is still lower than the national average of 36 percent.

The output of large-scale farms developed differently by subsectors. The production of crops fluctuated, owing to the droughts of every second year. This can also be seen well in the averages for production. However, the production results of 1992 were low not only because of adverse weather conditions. The 26 percent decrease in the output can be explained by the diminishing area of sown land, and also by the shortage (and lack) of the necessary inputs. The figures for animal breeding were stagnant up to 1988. Then, from 1990 on, they declined at an accelerating rate.

The performance of small-scale agricultural production between 1986–1992[2]

The weight of small-scale production within the gross production value of agriculture gradually increased and by 1991 it reached the level of 46.4 percent. Its proportion in the two main sectors was different. The share of small-scale production, by 1991, achieved 41.6 percent in crop cultivation, and 52 percent in animal breeding. The reason for the growth in the share of small-scale production was primarily the regression of agricultural production and, within it, the declining performance of large-scale farms. However, in the case of crop growing it was not merely the general regression of production that explained the forging ahead of small-scale production. In the cultures that were considered earlier exclusively

[2] In the following it is primarily the studies of *Harcsa, Laczka, Oros and Schindele* (1992) and *Oros* (1992) that have been referred to.

linked to large-scale farming—such as the growing of cereals, leguminous crops, crops for industrial processing, voluminous and succulent fodder—the smallholders strongly increased their production. Moreover, in the case of animal breeding, livestock in the possession of smallholders was stagnant, or lessened at a slower rate than it did in the large-scale farms. With regard to 1992, data are not yet available, and thus small-scale production's share in production can only be estimated. In the case of various species of animals, the share of small-scale production everywhere increased. The background of this process shows that the livestock of the smallholders was stagnant, or decreased at a lesser rate than was the case primarily with the cooperatives.

Examining the gross production value of the small-scale farms, it can be observed that only 2.5 percent of them (36 thousand farms) reached 500 thousand forints. In these households it can be presumed that this income accounts for the overwhelming part of the total income of the family. 10.6 percent of the small-scale farms (149 thousand farms) produced a production value of between *200–500* thousand forints. These may still be considered as units which produce a significant part of the household's income. The proportion of the two groups together (13.1 percent) is similar to that found in the course of sociological studies that were carried out in the 1980s, when the aim was to determine the number of entrepreneurs. Iván *Szelényi* (1992) estimated the ratio of entrepreneurs to be 14.9 percent, while the investigations of Imre *Kovách* (1988)—on the basis of another typology—of 11.8 percent.

Even in the agriculture of the advanced countries, farms operated on a part-time basis have significant weight. However, these tend to specialize in non-labour intensive activities which require extensive use of land. In Hungary the smallholders specialize rather in products which need intensive land use.

Development of price conditions in agriculture

From the second part of the 1980s the inflexibility of the price system gradually loosened; more and more groups of commodities came out of the sphere of the official prices. In 1989 an oversupply appeared in the market of cereals and consequently, the *Németh*-government decided to liberalize the prices, except for the bread-grain and milk.

Despite price liberalization, over the past three years the agricultural price conditions have developed unfavourably for the farmers. Between 1986–1989 state purchasing prices for agricultural products moved parallel with the prices of industrial inputs. However, after 1990, the gap between the prices of agricultural and industrial products suddenly increased. The leaders of the organizations safeguarding the interests of large-scale farming were, in the late 1980s, already protesting

against price conditions which were disadvantageous for them (in 1989, during the harvest, a demonstration with combineharvesters was organized). However, the statistical data did not justify the classical complaint coming from the agricultural lobby. Why did the large-scale producers still feel that they had fallen into a worse position?

In the study of Gyula *Gaál* (1989) a sensible answer is given to this question. In the period up to 1987 the data did not confirm the obvious explanation that an increasing volume of productive consumption was strengthening the effect of the input price rises. The development of the volume of the output, however, presents a better basis. In agricultural production the connection between productive consumption and the quantity of output is looser than it is in other sectors of the economy. For example, if an input of six tons of wheat per hectare is reckoned with and, owing to a draught, the yield is only five tons, it is poor consolation that the price index of the inputs does not exceed the index of the production prices. Despite growing expenditures, the incomes of the agricultural enterprises decreased and it is well-known that, over the last decade, draughts were experienced in every second year.

More important than the details given above are the *structural differences*. The selling prices increased almost at the same rate. The prices of the inputs, however, grew higher in crop production than they did in animal breeding. This circumstance was complemented by the effect of the various changes in the volume: the productive consumption needed for a unit of production decreased in animal husbandry but increased in crop cultivation. The different trends of changes were harmful to the profitability of crop cultivation (in other words, the major part of the basic activities in agriculture). This was the fact which elicited such passion against the gap between the agricultural and industrial prices.

Since the time Gaál's quoted study was completed the structural effect has strengthened. After 1988 the share of crop cultivation within agriculture's gross production value showed a further increase. At the same time, the price indices of buying up in animal breeding exceeded the price indices of crop growing (except in the year 1990). Nevertheless, it is fair to ask whether the price scissors afflict the producers merely in Hungary, or is it also the case in advanced countries?

With the industrialization of agriculture the phenomenon of the price scissors came to be a general one. A rapid growth of yield per unit of area and of labour productivity significantly increases the income of those who are able to use the opportunities. The agrarian price scissors cut down that part of surplus income of agriculture which is not appreciated by the market, by the growing demand for the inputs of industrial origin, and by the increase of agricultural products.

According to the investigations of *Németh, Oros and Vígh* (1991), between 1980–1987 the buying-up price indices of Hungary developed in conformity with the average in Europe; they were in a position between the respective positions of the United Kingdom and of France. However, it has to be noted that in this period

the prices of buying up were declining in the Netherlands and the FRG. If, in the analysed period, we compare the prices of agricultural products and of machinery in the West European countries, the prices of machines increased at a rate higher than the rates for agricultural products. However, owing to the varying contents of the price indices needed for calculating the price scissors, only the trends of the price changes can be compared. Accordingly, in the European countries (with the exception of the Netherlands) the prices of inputs of industrial origin everywhere exceeded those of agricultural products. The agricultural price scissors were the highest in the FRG.

Development of the budgetary relations of agriculture

In Hungary it is almost a commonplace statement that, since 1982, agriculture has been a net payer-in to the budget.[3] In the following the budgetary relations of agriculture in the period between 1986–1992 are examined (see *Table 3*). Although the results of the studies lean in the same direction, there is no year in which they show the same amounts of subsidies or collections. The differences stem from the different sources (while the data of Sipos and Halmai and the MOSZ come from the enterprises' balance sheets, those of the OECD are derived from the Ministry of Finance). They are also due to the differences in methods. According to the MOSZ and the OECD studies however, the subsidies granted to agriculture continuously decreased. They fell by the greatest amount in 1986–1992; in the reduction of this period it was the *Németh*-government which played the greatest part. In connection with tax collections, data are available only until 1991. However, the computations of Sipos and Halmai (1992) and of the MOSZ show contradictory trends. According to the former study an increasing trend can be observed in the budgetary collections after 1988, while according to the latter one, a declining trend can be observed. However, the differences cannot be explained by the fact that in the study of Sipos and Halmai the banking costs were also counted in the budgetary collections, because the MOSZ exhibited greater collections in 1988. Nevertheless, both papers support the agricultural complaint that "the budgetary relations of agriculture are characterized by a worsening position". Even so, serious objections can be made about the above methods of calculating the budgetary collections.

As Gaál (1991) expounded it in his debate with *Vági* (1991), it seems that these items cannot be counted in the budgetary collections. In other words, the social insurance rate is independent of the budget; if we want to count the social insurance rate in the collections, the income side also ought to be numerically

[3] Of the essays dealing with the subject matter we primarily stress those which contain longer chronological lines, such as *Vági* (1991), *Sipos and Halmai* (1992), *MOSZ* (1993), and OECD (1993b).

Table 3

Budgetary relations of agriculture between 1986–1992 (billion forints)

	Subsidies			Budget collections		Balance	
Year	(1)	(2)	(3)	(2)	(3)	(2)	(3)
1986	23.1	n.a.	32.2	n.a.	51.8	n.a.	−19.5
1987	27.9	n.a.	39.9	n.a.	56.8	n.a.	−16.9
1988	29.7	30.5	24.5	52.2	46.9	−21.7	−22.4
1989	23.7	26.0	30.6	58.0	60.2	−32.0	−29.6
1990	13.9	19.0	23.8	54.2	65.9	−35.2	−42.1
1991	6.3	12.2	13.5	48.2	64.2	−36.0	−50.7
1992	5.0	6.1	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: (1) OECD 1993b; (2) MOSZ 1993; (3) Sipos and Halmai 1992.

quantified to see how much pension, accident benefit and sick-pay was granted annually to agricultural workers. It is also not valid to count the banking costs in the collections. That is to say, in this case a relationship of offering and receiving some services is in hand. Here in fact, relations of dependency remain dominant, but this is so even in the other external relationship of agricultural producers. Furthermore, if a banking institution would, in its relations with some agricultural sectors, exhibit permanently passive balances, it would very likely go bankrupt.

Leaving the social insurance rates out of consideration would basically change the position of agriculture towards the budget. *Udovecz* (1992) made an interesting comparison about the year 1991. In his computations he separated the direct payments of the sector (enterprise profit tax, land tax, customs duties, dividend for state property), turnover tax and consumption tax, personal income tax, and the social insurance rates.

According to his examinations, agriculture would be a net payer-in if the social insurance rates were to be counted in the budgetary collections. If it is only the direct payments that are taken into account, the sector would be granted a net subsidy of 12.3 billion forints. It must also be noted that it is questionable whether it is feasible to consider the personal income tax which is paid by the employees (a budgetary payment), or the turnover tax and the consumption tax which are covered by the consumers. At the same time, the subsidies do not contain contributions that would cancel out some credits and debts, or even export allowances.

The budgetary relations of agriculture cannot be considered without the food industry, for the subsidies granted to the processing sphere, to a significant degree, serve the production of the basic materials. According to the calculations of both the OECD and the MOSZ, in the analysed period the amounts destined for subsidizing the food economy were gradually declining. The drastic reduction of subsidies

(to agriculture) occurred during the time of the *Antall*-government. According to the studies of the MOSZ, the budgetary collections were increasing until 1990. In the following years they declined, but not even the growth in 1992 reached the level that had existed two years earlier. The balance of the food economy towards the budget, owing to the vast decrease of subsidies, continued to deteriorate. However, it is worth recalling that the calculations of Udovecz presented above, led to results similar to the foregoing ones. If the direct payments of the sector are compared with the subsidies, the food economy in 1991 obtained a subsidy amounting to 25 billion forints.

Since no chronological data about the structure of budgetary collections are available, only two hypotheses can be formulated. On the one hand, it is unlikely that the "cleared", net budgetary balance of the food economy was negative; on the contrary, there is no doubt that in the recent past its subsidization diminished.

Development of the agricultural market and the collapse of the CMEA market

Between 1986–1992 agricultural exports increased dynamically, with the value of food exports increasing by two-and-a half. While the food exports were growing dynamically, they had to fight against ever increasing problems. In the international market of mass commodities that represented the bulk of Hungarian agricultural supply (cereals, animals for slaughter, meat at a low level of processing etc.), in comparison to the paying demand an oversupply developed.

The purchasing behaviour of the Soviet Union played a key role in Hungarian agricultural exports and in the sales directed to the CMEA markets, but around this time a fundamental and lasting change came to pass. By repressing the purchases for convertible currency, the Soviet party endeavoured to shift the majority of Hungarian trade over towards the more unfavourable transactions accounted for in roubles.

The growth of the output and export of food products was not accompanied by an adequate adaptation to the requirements of the international markets characterized by a more demanding consumption level. The automatic functions and conditions of operation, or regulations which might have made the agricultural economy suitable for adjusting to changing, high-quality needs, and for the organic integration into the different markets did not take shape (Lányi 1985). The chief objective of Hungarian agricultural policy was, in addition to a steady domestic supply, to produce large volumes of certain commodities which could be exported. In the 1980s the main products within the sphere of food exports came to be markedly outlined. Approximately 60 percent of exports consisted of cereals and meat, and if these products are added to the products of horticulture, a ratio of 80–85 percent is obtained. It is conspicuous that over the past fifteen years the

division of exports by product groups changed only very slightly. Raw and primarily processed products represented a major share—such as animals on foot, raw meats, slaughtered animals, cereals, fresh vegetables and fruits. At the same time products expressly destined for exporting (e.g. preserved and deep-frozen products, tinned ham, edible oil, and processed game) also appeared.

Agricultural exports were basically built on the requirements of the Soviet market.[4]

In 1989, for instance, 75 percent of the wheat exports, 35 percent of corn, 59 percent of beef, 31 percent of pork, 30 percent of wine and 44 percent of champagne exports were delivered to the Soviet Union. The proportions are even more alarming if it is taken into account how much of the domestic production was destined for the Soviet Union. In the case of the production of apples this amounted to 25–30 percent, in that of wine and champagne it came to about half of the total, with chickens it totalled one-quarter, and in the case of wheat it came to 25–39 percent.

In the Eastern trade, owing to the failing counterparts, to the decline of payment on demand, on behalf of both the Hungarian and foreign parties, to the imposition of administrative restrictions, the loss of ground on the former CMEA markets started and began to accelerate in 1989. The narrowing of the East German market was already a fact in 1989; nevertheless, it was mainly in 1990, after the union of the "two Germanys", that the united German state began to compensate for the quantity lost. From 1989 on, the Soviet Union restricted the quantities of some Hungarian wares produced in volume, and expressed that the composition be in conformity with Soviet requirements (i.e. with regard to horticultural products, canned food, alcoholic drinks).

Owing to the distortion in the rouble exchange rate, the orientation towards the East European (mainly the Soviet) markets remained much stronger than shown by the value data. With regard to the quantitative data, the weight of the former Soviet Union in the Hungarian agricultural exports was in fact much greater and, in the case of certain products (e.g. wheat, champagne, certain products of the canning industry, apples etc.), continued to be of crucial importance. At the turn of the decade it was primarily the convertible exports to the Soviet Union that were reduced; on the other hand, despite a certain decline, 75–80 percent of the total agricultural exports for roubles were destined to go to neighbouring countries. If the agricultural exports in forint value are examined, it can be seen that it was—by and large—constant from 1986 on. In the critical years of 1990 and 1991, there was even some growth. It can rightly be stated that it was by no means the "collapse" of the Eastern markets that was responsible for the crisis of Hungarian agriculture (Lányi 1992). In 1992 the share of the former socialist countries or, of the Commonwealth of Independent States, in the total of the food exports actually showed a further increase. What is more, about half the exports destined to the former

[4] In the following reference will be made to the work of Lányi (1992).

Soviet Union were in the form of food. However, maintaining agricultural exports to the countries of the Commonwealth of Independent States involves risks: there is a permanent shortage of foreign exchange on the part of the customers, there are the risks of bartering and transport, and the lower frequency of relief shipments. From the aspects of financing and marketing, the participation of western mediators counts as a stabilizing factor. The ratio of these mediators in the agricultural exports, according to calculations of the Ministry of International Economic Relations, reached the level of 21 percent in 1992. However, neither the relief shipments, nor the business transactions via mediators are in fact profitable.

The regime made conscious efforts to enhance sales in the West, where, in the case of certain products (e.g. pork) there was consequent growth in demand. The easier terms of trade following the agreement between Hungary and the Common Market in 1988, and those received from the EEC from 1990 on, all had a beneficial effect which helped to increase agricultural exports. The growth of the Western exports, however, after a brief period of growth began to decline in 1992.

The most important questions of ownership transformation

A necessary but insufficient condition for transforming the farming system is the arrangement (or re-arrangement) of ownership relations. The conservative regulations that guide the operations of the agricultural cooperatives, regardless even of the political changes, can no longer be maintained (*Gaál and Juhász* 1988; *Herbst* 1991); moreover, it has also become absolutely essential to settle the land question: further postponement would have daunting consequences.

Transformation of the agricultural cooperatives

In 1990 the new government set itself the task of solving the land question. In 1991 the law on compensation was enacted. Since that time, among other things, the legal provision accelerating the acquisition of land, the transitory law on cooperatives containing the principles for marking out the land, and the law on cooperatives have also been enacted. The laws were aimed at solving two problems: on the one hand, the division of the land owned by the cooperatives and, separately from this, the division of cooperative property.

With regard to the effect of the above-mentioned laws the ownership structure of lands used by the cooperatives has completely changed. The most significant change has been the termination *of the cooperative as a property form*; this has resulted in a process of compensation, and the division of the land among the former members of the cooperatives. For the purpose of compensation 1806 thousand

hectares, (approximately 53 percent of the land property of the cooperative) were allocated. For the former members and employees of the cooperatives altogether 814 thousand hectares (24 percent of the common land property) were marked out for compensation purposes. The remaining 764 thousand hectares of land area serve for marking out rented property.

Another significant element of the cooperatives' transformation has been the *division of common property.* Within the framework of this, a decision had to be made about the future of the property in more than 1400 cooperatives, amounting to a value of HUF 260 billion. Of this, HUF 11 billion is due to be paid to those who are still cooperative members (both active workers and pensioners), in the form of cooperative shares. The cooperative is obliged to pay this amount to the members when terminating the membership, to at least the nominal value of the share certificate. The average value of cooperative shares was HUF 20.9 thousand.

The remaining property, worth about HUF 248 billion, was divided among those entitled to a share, implying a total number of more than 1.1 million persons. Of the entitled, 289 thousand are active cooperative members, 351 thousand are pensioners, 29 thousand are employees, and 484 thousand are former members and successors. Accordingly, after the implementation of the law, the active cooperative members and the employees (in other words those who are still working) have at their disposal hardly 40 percent of the common property of the cooperatives. The share of the pensioners in the common property amounts to about 39 percent. For them, however, their share of property does not mean a job opportunity, but an additional source of income. Almost 20 percent of the cooperatives' property was granted to outsiders, of whom today there are only few who would undertake cultivating (individually or in common) the property granted to them; according to the law, however, they have no actual say in the business decisions of the cooperative.

The vast majority of the transformed cooperatives (90 percent) continue to be productive. Significant internal changes of organization have occurred in only a small minority of them, or as the co-workers of the Ministry of Agriculture formulated it: "Merely the legal implementation of the law has been carried through."

The lessons so far from the transformation of the cooperatives

Taking a look at the effects of the laws affecting the transformation of the cooperatives, it can be found that they have promoted neither the economically rational dismemberment of large-scale agricultural enterprises, nor the improvement of the conditions of private farming. The regulation separated the "privatization" of land and of the other cooperative property. Consequently, a significant number of the (expected) more than two million landowners possess no means of agricultural production. At the same time, the majority of those possessing the means of

production do not have sufficient land for profitable production. Hence, there will be more landowners than the actual number of those who utilize the land.

As a result of the law on cooperatives the external capital owners who possess a proportion of the business shares of the cooperatives, if they do not enter the cooperative as members or are not admitted, have no right of voting in the organization of the cooperative; even at the assembly they are granted no more than the right of consultation. Thus an association form has been created in which, nationwide, about half a million bearers of stocks have no licence of decision in the enterprise in which they have partial ownership. In addition to this, there are "outsiders" who, despite the fact that they have received nominally a significant property, feel that this is no more than a paper. This is due to the fact that, having knowledge of the current profitability relations of agriculture, the dividend gained by the shares will be zero or have only a negligible value.

The laws on cooperatives have created formations which are merely pseudo-cooperatives; despite their legal nomination, they are not real cooperatives (Herbst 1993). In the past, a generally accepted conceptual element of the cooperative was the common economic interest, but this did not involve capital utilization. For the purpose of promoting common economic interests, those cooperating participated in the activities of the cooperative, by personal collaboration, or by involvement in its activities (processing, selling, purchasing, crediting etc.). In contrast to this, the cooperatives that have now come into being on the basis of the Hungarian law on cooperatives, are in fact disguised cooperatives, also with respect to the feature that the external capital investors are exclusively connected to the cooperative by the motivating factor of capital. The structures which have come into being are inadequate, not merely as cooperatives but as associations of capital, for the outsiders have no licences based on capital ownership. The transitory law, at the same time, has forced the large-scale farms to follow a cooperative model (which, in addition, bears the feature of productive cooperatives). This is because the transforming cooperatives have no other alternative than to become "new-type" cooperatives, or to form economic associations.

The position of the transformed cooperatives is also aggravated by the protraction of the compensation process. In other words, they do not know how much land was sold (or will be sold) in the course of the prolonged auctions. Owing to this unclear ownership structure it is not easy to see from whom land can be leased, and on what conditions.

Experiences gained so far in the transformation of agriculture

Agriculture—proclaimed earlier to be a "success sector"—by the late 1980s, had fallen into an increasingly deep crisis. The success was fairly relative: although

Hungary, compared with the other East-European countries, had a more developed agriculture, in comparison to the advanced countries its efficiency placed it no higher than the middle of the field. The Hungarian agricultural system was similar to that of the other former socialist countries. Hence, the transformations of agriculture in Hungary and in the other countries of Eastern Europe have so far shown rather similar characteristics (OECD 1993; *Cochrane* et. al. 1993; *Ash* 1992). At the same time, the differences which had developed between the Hungarian and the other East European countries, had been strongly fixed by the institutional system of the planned economy (Juhász 1988).

In the second half of the 1980s the crisis of the Hungarian agriculture became clearly apparent. It was not caused by the unfavourable change of some partial circumstance (such as the agricultural price scissors, declining subsidies, or the sinking of the world market prices), but had also certain deep-rooted structural reasons. The crisis can be explained mainly in terms of organizational problems; beside these there have been efficiency and financial difficulties, and also structural and marketing troubles (*Fertő, Juhász and Mohácsi* 1991). That interpretation which claims that Hungarian agriculture was precipitated into crisis by the reduction of subsidies and changing ownership relations does contain some grains of truth, but it is misleading. In the 1980s the growth of agricultural production came to an end, in the large-scale farms incomes began to decline, and the technical level of production could no longer be maintained. After 1990 the process of regression accelerated. Parallel with this, the ratio of small-scale production within total output gradually increased.

Owing to the liberalization of prices and the reduction of subsidies, the consumer prices (among them, those of foods) considerably increased and, since incomes did not keep level with the rate of inflation, domestic demand for foodstuffs fell drastically. Simultaneously the prices of agricultural inputs also increased and thus the agricultural price scissors grew wide open. The growth of the agricultural exports, however, continued. This is seemingly a contradiction, given the slackening of agricultural production: namely, in the short run production was only able to adjust to the declining demand in an inflexible way. Therefore in the case of certain agricultural products an oversupply occurred, and endeavours were made to sell the surplus on foreign markets. The sector pulled through the collapse of the Soviet and CMEA markets more easily than was expected. At the same time, exports to the OECD countries and, within them, to the EEC increased. Paradoxically, in the development of the market problems of Hungarian agriculture it was not the narrowing external markets that played a decisive role, but the reduction of domestic demand.

The most significant elements of the changes were the land question and the transformation of the large-scale agricultural enterprises. In the framework of compensation, attempts were made to give back agricultural land to one-time owners. This process has, up to now, been unsuccessful. Namely, compensation

did not allow a rapid transformation of the ownership relations, and thus it caused a very high level of uncertainty in the system of farming organizations. Thus, the already unfavourable external economic circumstances for agriculture were made worse by a new problem, the effects of which could be seen in the further decline of production. Another negative feature of the process is that there are only a few individuals who want to farm the land they have regained. Those currently working on the large-scale farms want to continue working in some successor organization of the collective or state farms because they are afraid of the great uncertainty surrounding the sector.

The new government faced the task of, simultaneously, coping with the crisis, liquidating the socialist system of agriculture and building up a new up-to-date agricultural economic system that would be able to adjust to the various market requirements (*Juhász and Mohácsi* 1993). However, the activities of the *Antall*-government were bifurcated. On the one hand, it commenced the transformation of the system of agricultural organizations. However, the laws on compensation and on cooperatives, in contrast to expectations, promoted not transformation but the conservation of the farming system. The other activity of agricultural policy involved dealing with the permanently occurring mini-crises. Yet the operations of the new government continued to deepen the overall agricultural crisis.

However, what has been said above does not explain the fact that, beside a general reduction in production, in some particular markets an oversupply or shortage appeared. Among the agricultural producers there is still a lack of ability to adjust to the market and their activities are driven by the constraint of subsistence. *The main reason for this is that in Hungary the agribusiness—i.e. the networks for producing the inputs of agriculture, for processing, for marketing products and for the services belonging to it—has not been developed.* With the lack of the structures of agribusiness and of operative agricultural markets, the producers continue to pursue their operations without adequate information. Consequently, they blame the government for their troubles. The most serious inheritance from the past is that the earlier system of imperfect collaboration was broken up before the *new market institutions* had been formed. Thus the uncertainties and difficulties stemming from the past have grown stronger, and at a higher degree than was expected.

The transformation of Hungarian agriculture is still at the beginning; but even so the question may be raised with regard to the direction in which Hungarian agriculture is going to develop. It seems that there are two questions worth stressing in the light of international commentaries. The first one asks whether the large-scale organizations will survive or will be replaced by family farms. The second question concerns the part the state should play in the transformation of agriculture.

In the opinion of *Schmitt* (1991a;b) the failure of collectivized agriculture was necessary and, at the end of the process of transition into a market economy, family farms will replace the large-scale farms run by wage labour. In his explanation he

refers to the transaction costs. In the first part of his reasoning he endeavours to give an answer to the question as to why the family farms have survived and become dominant, in contrast to the large-scale farms in the advanced countries. The first problem asks why the large-scale organizations cannot realize the advantages stemming from the returns of scale owing to their size. According to Schmitt the costs of organization and transactions considerably surpass the advantages of the scale returns. The family farms can more easily solve the problem of freeriders and principal-agents who emerge in greater numbers as a farm grows in size. In a socialist economy these problems appear much more strongly, for the actions of the farms are driven not by the signals of the market, but by the direct or indirect influence of the state. As a result of the above, even in the stage of agricultural transition, the family farms are going to replace the large-scale organizations. However, Schmitt also stresses that this process cannot be implemented without significant support being provided by the state.

Yet in the case of Hungarian agriculture the above-mentioned state support has remained at the level of empty slogans. The growth of family farms has been blocked by several hindrances, such as the disproportionate nature of rural infrastructure, the low power of agriculture to attract capital, and the defects of the present system of financial institutions. Hence, it is unlike that the proportion of full-time entrepreneurs will markedly increase. At the same time, there is the circumstance that the weight of farms operating on a part-time basis will continue to be decisive. Moreover, it cannot be expected that significant changes on large-scale farms will occur: in other words, the laws will not prompt them in the direction of dismemberment but will preserve their former structure. Given the two ways of agricultural development (*Lehmann* 1982), it seems that Hungary will not follow the trend of the advanced countries, but that of the South American model: the dualism of extensive large-scale farms employing wage-workers and the self-supporting dwarf holdings.

Almost every foreign expert believes the role of the state to be decisive in the process of agricultural transformation. *Braverman and Guasch* (1990) stressed that the task in Eastern Europe is greater than it was in the developing countries, for the changes have to be more comprehensive. Furthermore, the governments should take into account that their reform programmes must be acceptable for both parts of the population, i.e. for those involved in agriculture and for the rest, too (*Hagedorn* 1991). Experience in the developing countries shows that without social acceptance and without detailed compensation for those suffering losses owing to the transformation, no successful agricultural reform can be carried through (*Rausser* 1990). The success of the transformation in agriculture depends, on the on hand, on the general economic situation of the country concerned (i.e. on the success of the stabilization programmes); on the other hand, it depends on world trade. Therefore the governments have to try to stabilize their agricultural markets in order to create a favourable atmosphere for long-term investments; in addition,

despite the limited possibilities, governments should support the agricultural sector in the short run. Without doing so, the initiation of agricultural development in Eastern Europe cannot be imagined (Ash 1992). Other analysts warn the countries of the region against adapting the protectionist agricultural policies of the advanced countries (*Tracy* 1993).

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Acta Oeconomica, Vol. 46(3-4), pp. 423-436 (1994)

BOOK REVIEWS

CSABA L.: *Az összeomlás forgatókönyvei. A rendszerátalakítás alkalmazott közgazdaságtana* (The scenarios of collapse. Applied economics of systemic changes). Budapest: Figyelő Kiadó Rt. 1994. 287 p.

In the middle of the eighties, on a summer afternoon, a few economists gathered to chat in a relaxed atmosphere (at their workplace, but drinking red wine). They were colleagues, and although they were experts in different areas, they shared similar professional and political creeds.

The chat was about the fate of the "empire" in its narrower and broader sense, a few months after Gorbachev's access to power. The participants were weighing the probable—i.e. the imaginable—chances of the Soviet Union's transformation. It was mentioned that the CPSU and the military were opposed to the reforms suggested by the intelligentsia. At the same time it was suggested that they might support certain centrally managed modernisation processes. Some of us were thinking about the cautious advances of Hungary and Poland on a "quasi"-Yugoslav road. The dismantling of the CMEA and the Warsaw Pact, the falling apart of the Soviet Union and Yugoslavia, the "split" in Czechoslovakia, and German unification were not mentioned; nor were the boldest variants of privatisation, shock therapy, asset management by the state, or import liberalisation.

It would be in vain to think about how much we did not know or did not see in advance. However, in 1994 the above-mentioned events and ideas are now decreasing in importance. In a few years the tasks of transformation have more or less been achieved. What has remained is the job of analysing the management of the crisis—with "transformation" or without. This is the hardest lesson.

László Csaba's book is a valuable and contrasting picture about an important transformation process—in fact a process without political and economic precedent. It represents the crossroads of development, offering a broad perspective showing the most important results of the economics of transition. Some of these results show that certain changes have not been as durable as others. In other words, there are aspects of the transformation which have not been comprehensive enough and sometimes their contents have been more political than economic. Nevertheless, many of these features of the transformation have already found their way into Western textbooks on economics, and teachers and students of comparative economics no longer represent a small group of the initiated.[1]

Just at the time László Csaba's book has appeared, a borderline has been crossed. This means that in the leading countries of the transformation process the institutions of a market economy and "pre-integration" links with the European Union have been created. Today we know for certain (unlike in the past) that the "vanguard" of the transition to a market economy (i.e. the Visegrád countries, Slovenia, and perhaps Estonia) are not finding the way easy; theirs is not the "textbook" way at all. It is probable that subsequent waves of transformation will follow yet other paths and will advance through even more difficulties before they reach a state of well-being and democracy.

László Csaba's book is strictly pragmatic in its approach, and uses an immense literature. It comments on the facts and leaves aside any speculation. These are features of all truely scientific books. However, this book has another message, which can perhaps be described as "epistemologic".

Deep analysis of the pitfalls of Central- and Eastern European transformation has proved that economics: (1) has not been able to really forecast the content and the extent of transformation tasks; (2) has not been able to provide a suitable "tool-kit" for economic policy, preparing it for unavoidable tasks (3) did

[1] I too might say about metaphysicians what Scaliger said about the Basques: "They say they understand each other but I do not believe it". (Chamfort)

not take sides in professional problems of transformation.

It belongs to the latter problem that there is still no development economics of transformation (although the bulk of the Soviet successor states, and perhaps some countries in the Balkans belong to the Third World). Moreover, it is not clear what development theory has to say about a shrinking GDP—which is a process that has gone on for several years now. The main problem is that the analysis of, and indications for transforming economies are built on shaky methodological-statistical foundations. Therefore, quantitative research is not only inaccurate, it is also misleading, and its margin of error in forecasting is too large.

László Csaba's book, looked at in a philosophic sense, demonstrates that the apparently comprehensive and deep analyses of real processes have in fact lagged behind reality—at least in the region and time period that he has investigated. This interpretation is substantiated beyond the content of the book by its symmetric structure.

Chapters one and six deal with the first problem which arose: crisis or transformation? To twist somewhat the words of the author: is there a crisis which is transforming itself, or has the transformation got itself into a crisis? Reading the book it is not difficult to see that the answer is not implied by the question. In fact, to define the two terms figuring in the question is more difficult than to give an answer.

Parts two and five deal with preconditions, the framework of crisis, and transformation. Under the initial conditions it is not only the origin and the fate of the "empire" that have been important. It has also been significant that the "empire" itself was a mere episode in a longer historical process. In other words, since the "empire's" disappearance several problems that first appeared centuries before 1917 (or 1945) have again presented themselves as complications demanding solutions.

At the same time transformation and crisis are enfolding in an international environment which is rapidly changing, but in an unpredictable direction. From among the different points of orientation the European Union is compelled to redefine itself. The American economy is struggling—with various degrees of success—with the task of winning back its previous leading position. The Far-East has to recognize that its rapid advance in the rank order of economic development entails serious equilibrium problems.

The title of *Chapter 13* ("What kind of capitalism is waiting for Eastern-Europe?") suggests cautiously that the region—primarily referring to all CIS countries—marching on an avenue towards a market economy will arrive not at the Fifth Avenue or Bahnhofstrasse, nor in a small town in Catalonia or Burgenland, but at best in a poor but orderly Szeged, Kosice, or Kraków.

The centuries-long organic processes of development and accumulation cannot be curtailed and reduced over a few decades—neither in a material nor in an intellectual sense. The experiment might be successful, but the changes of failure also loom large. Forced modernisation might again prove to work against inflated expectations, and it might entail costs that have to be paid over a long period of time.

Parts three and four are devoted to economic policy. After formulating the research task and reviewing antecedents, the exciting question centres upon issues such as how one should initiate transformation, how to measure its success, how to arrange information, and how to offer all this to decision-makers.

Among the 14 chapters, it is in the 8th (i.e. in the middle of the book) that the critical question is formulated about the role of economics in the transformation. The author believes that the performance of trade has so far been deficient. The causes are seen in the confusion, the weak methodological foundations of Eastern European economics, the turning of its interests increasingly towards empiricism and microeconomics, and away from "serving" economic policy.

Another important cause is that several outstanding Western economists did not exactly offer the best of their knowledge to Eastern European transforming countries: "... the economic knowledge offered to transforming countries (or acquired by them) is not the wise product found in libraries, but the intellectual by-products of some brilliant minds tempted by the situation to go on an excursion (a fanciful trip) into the jungle of poli-

tics." (p. 149). On top of that the "translator programmes (the term was coined by László Csaba) have not been successful, despite their aim of using in Eastern Europe scientific results which have been applied in the different circumstances of developed market economies. Yet what is the aim of these "translation programmes"?

One of the subtitles of Chapter 8—"The conditions for understanding one-another"—points cautiously towards an important professional goal and requirement. This section of the chapter formulates an important methodological attitude and research programme which is much more open than the previous ones. The aim is that the empirical findings offered by the process of transition and the theoretical considerations of economics should cross-fertilize each other. One cannot allow the two to develop in a parallel fashion, as they have done up until now.

Healthy development should not only be general but specific in our region. There is a need to be better armed with "mainstream" economics, and to understand more about other directions disfavoured at present. Furthermore, it must be judged whether official recognition is in line with a particular direction's true value or not. "We search in vain for a royal path: beyond the neo-classical mainstream we have to know the latest results of institutional economics, and of the analysis of bureaucratic systems." (p. 158).

We have to recognize that economic research is closely attached to linguistic and cultural barriers, and thus we have rely more on German, French and Italian results. Research into trade policy, privatisation and industrial policy can learn from Latin examples; the German language area can teach us how regions on the periphery can catch up, whether this be in a country or in a European context.

Without making it clear what quality and measure is to be attached to the role and responsibility of the state, and without making clear the transformation and crisis management functions of the institutional system, nobody can help transforming countries. They can only cure their spoiled brethren with prescriptions not originally intended for them. We have to recognize that our kinship is not strong, and thus before applying a new medicine one should ask about the health and the ideas of the patient.

There have been cases in which a sick child with wealthy and healthy relatives or patrons is not recommended for a radical cure; in other cases a host of determined doctors and nurses have flocked into the child's room. László Csaba builds the fourth part of his book on an analysis of the economic policy of transition using a case study of Hungary, and another one of Russia. I would like here to call the attention of the author to the limits of generalising these two examples and the necessity of investigating at least two other examples (i.e. the Polish and the Czech).

The analysis would have become thereby much more differentiated and smaller countries struggling with their own transformation problems might have chosen among more relevant examples. However, it is true that the balance of the book might have been broken if this had been done.

The Hungarian case is reviewed in chapter 10 ("The myth of Hungarian gradualism"). It is not an irrelevant question to ask who developed the myth of the "Hungarian way"; was it politicians, or was it economists? Furthermore, did the Hungarian way exist at all? László Csaba reveals that gradualism as a Hungarian reform principle has roots going back several decades. This attitude—fortunately—has such deep roots in Hungarian political and economic thinking that any kind of elite, whatever its colour, dealing with the problems of transformation has to adapt to it.

This attitude shields us from the grave consequences of errors that have been made but shifts the burden of tasks from the general staff to troop officers who organise advance and retreat. Market-conforming institutions and rules were created relatively early on in Hungary and they functioned in a smooth way. At the same time there was not such a huge stabilisation effort, as in the cases of Poland or Russia. "Hungarian economic policy made in the period 1988–1994 embodied several radical steps—such as the sharpening (not enlarging?—Á. Török) of the bankruptcy law, the adaptation of accounting to Western norms, the limitation of central budget financing through the central bank, allowance of

bankruptcies in the case of banks, the starting of the reduction of the dominance of the agricultural sector, the twins of revaluation and free trade. These are features which the heroes of shock therapy did not venture into. At the same time, in the areas where gradualism was needed—central budget, social security, banking system—the reform was stuck" (p. 194) Therefore, later, the problems caused by exaggerated gradualism will involve stabilization tasks.

The description of the situation is exact with one possible exception. Bankruptcy of banks is allowed in Hungary only if this happens with large, state-owned banks. In the case referred to above the participants were private banks and their problems were intruding into the area of criminal law where crisis management by the state was not a feasible alternative. Such cases do not demonstrate anything beyond the responsibility of bank supervision.

This book by László Csaba is an important summary of the comparative economics literature stressing economic policy aspects. Beyond that it also has a theoretical meaning too, even if it is not a heartening one. Its accurate style is not immersed in professional jargon, and this makes it suitable for a wider audience.

Since the author himself makes his book more readable through literary references, let me quote an aphorism by Stendhal: "Political ideas in a literary work are like the shooting of a rifle during a concert." Indeed, László Csaba has avoided throughout making references to day-to-day politics, even though his subject has a direct bearing on contemporary issues.

Á. TÖRÖK

BATES, R. H.–KRUEGER, A. O. (eds): *Political and economic interactions in economic policy reform. Evidence from eight countries.* Oxford (UK) and Cambridge (USA): Blackwell. 1993. 481 p.

The economic paradigm of the 50's and 60's held that the developing countries were "different". Economic relationships applicable to them were not the same as the ones to be applied when analyzing developed market economies. Therefore, economic policies with a chance of success also had to be different.

The desire to catch up with the rich countries almost uniformly led the developing countries to economic policies which assigned a dominant role to the state. In order to pursue industrialization or other development goals the functioning of the goods, capital and labour markets was restricted and heavily regulated.

True enough, there were significant exceptions. Still, it was not before the early eighties—in some cases only after the "second wave" of oil crisis—that the failure of this paradigm became abundantly clear. That is, it became obvious that the state was a poor entrepreneur and, despite the best intentions, direct state intervention had proved unable to secure long run and sustainable economic growth. This verdict became widely accepted.

In most of the cases the failure of the theoretical framework showed itself in the form of economic crisis. Large scale internal and external imbalances, financial collapse, inflation, unemployment and similar economic ills were quite commonplace in the developing world. To cure or at least to treat these diseases most of the governments tried to implement economic policy reforms and stabilization programmes, and these met with various degrees of success. To a certain degree this wave of economic policy reform in the eighties represents an almost complete abandonment of the previous paradigm.

The way most governments chose to get themselves out of the crisis was to decrease the role of the state in economic activities in general, and to make adjustments in the redistribution of goods, services and incomes in particular. This came parallel with the opening up of markets towards internal and external competition. Of course, the role of international monetary institutions—which offered financial assistance almost exclusively for this type of reform—was not at all negligible in the process.

This volume, edited by two of the best known experts in this particular field—Robert

H. *Bates* and Anne O. *Krueger*—contains eight of those economic policy and macroeconomic stabilization reforms. Apart from summarising the results of individual country studies, in the last chapter the editors attempt to find the common and general elements behind the successes and failures of those economic policy reforms. The eight country studies (Brazil, Ecuador, Egypt, Ghana, Korea, Turkey and Zambia) can be read independently, and this is also true for the final chapter, which gives conclusions. The busy reader has the additional advantage of not having to go right through all the four hundred and fifty odd pages: in other words, he or she can pick some chapters, and then turn back to the rest at an other time. Another useful point is that the individual studies were written as parts of the same research project coordinated by Duke University (Duke Project on Political Economy of Policy Reform in Developing Countries). As such, they have the same plan, the same methods, and they seek answers to the same questions.

Thousands of volumes have already been written on the economic policy reforms in question. What makes this one so interesting and outstandingly new is its special approach. In this research Bates and Krueger make an attempt to overcome the well known controversy between the representatives of political science and economics, while addressing and analyzing the issues of economic policy reforms. In most of the previous works there was a clear dissonance between these two disciplines. On the one hand, the political scientists considered the course of opposition to reforms and the political difficulties that economic policy reforms created, and bemoaned the economists' apparent naïveté regarding the politically possible. They focused much of their analysis on identification of the political prerequisites for successful reform efforts. On the other hand, the economists focused on the policy weaknesses that had previously existed, and lamented the partial nature of reform efforts. They were mystified as to why policies that clearly yielded inferior economic outcomes were being implemented. In a nutshell, what was good politics did not seem to be good economics, and what was good economics was not seen as good politics. Bates' and Krueger's research plan was to carry out analysis of reform episodes (or their absence) in individual countries. In this process an economist and a political scientist were to jointly address the economic and political issues associated with the need for reform, the reform measures undertaken, and the outcome of the reform process. The expected "cross fertilization" of the disciplines has been realized in the studies, and the reader can sense and enjoy the positive results of this.

While there certainly are general and common elements in the economic reforms in question, it is also clear that there are no two countries which are alike. For these, and other reasons, no attempt has been made to arrange country studies from a representative group of countries, since there was little basis to ascertain what "representative" might mean. Instead, the selection of the countries has been based on the availability of statistical data, on the inherent interest in an individual country's experiences and, most of all, on the availability of highly qualified researchers who could build upon their previous work in undertaking the task at hand. This rule of choice certainly played a role in the fact that not only well known cases were selected, but some of the less significant ones, such as Ghana and Zambia, as well. Moreover, some widely publicised success stories and failures were left out of the selection. Mexico is a good example of the former, while Argentina could represent the latter.

In their concluding study (Ch. 10: "Generalizations arising from the country studies") Bates and Krueger discuss the common factors explaining the initiation, political conditions and the final success or failure of the policy reforms. They also compare and contrast their own findings with other arguments in the relevant literature.

Some of these conclusions are quite straightforward. For instance, the research points out that reforms are triggered by serious economic difficulties, and that no country without an apparent crisis situation has ever contemplated major policy reforms. However, the nature of the economic crises can vary from time to time, and from place to place. The most frequent problems involve external imbalance, the deficit on the balance of pay-

ments, and the related high inflation and capital flight; these were the problems which confronted Brazil, Chile and Turkey. Another important factor triggering reforms is the internal economic chaos, the "withering away of the state": that is, a situation in which an ever larger share of economic activity moves into the half legal or informal sector. On these circumstances, there emerges the desire to restore state control and authority in order to prompt a programme of economic policy reforms; the latter, paradoxically, entail a reduction of state controls so that the effectiveness of the state can be increased! The crisis that prompts reforms is not always *economic*, for it is evident that popular discontent with ongoing aspects of the economy has also pushed governments to change their policy course. For example, popular revulsion with corruption was a significant factor in Korea, Zambia and Ghana.

Although it is easy to speak of economic "realities" "necessitating" policy change, there is in fact only a weak relationship between economic conditions and policy responses. Lying between economic circumstances and policy reforms is a political process by which the need for economic adjustment is translated into effective political demands which argue for policy change.

In the literature on economic policy reforms the state is often pictured as a strong, centralized institution—a platonic guardian which recognizes the need for change and takes the necessary action. Not one of the countries selected into this research was in such a situation. Rather, we have examples of struggles between the legislative and executive powers (Ecuador), of hostilities between various military and civil political forces (Chile, Turkey, Korea, Brazil), or of particular private groups exploiting public institutions (Ghana). Struggle among interest groups sometimes went as far as civil war (Chile). However, the platonic guardian state was definitely not apparent in any of the cases studied (nor has it been in any other).

The alternative model is the one that describes policy outcomes as a result of a power struggle between interest groups who, respectively, lose or gain from the changes. One of the most surprising findings of the case studies in this volume is the degree to which the intervention of interest groups fails to account for the initiation, or lack of initiation, of policy reform. Thus, while we do find businesses advocating changes in public policy, the business sphere is sometimes ineffectual (Turkey, Zambia), often fragmented (Ghana, Brazil) or quiescent. We find little evidence of labour trying to obstruct attempts at policy change. Either labour is compliant (Ghana), peripheral (Zambia), or repressed (Chile, Korea).

Why do organised interests seem to fail to shape reforms as decisively as one might expect? According to Bates and Krueger, the economic policy reforms they have dealt with were highly complicated and comprehensive packages; they involved much more than a simple increase or decrease of a single tax or tariff. The theory of interest groups could explain the latter with reasonable success, however, in the case of complex policy reforms. This is because the impact of the changes on interest groups comes through a number of channels and in various forms. Even the interest groups themselves experience difficulties recognizing whether the whole package improves or worsens their relative position. A significant consequence of this uncertainty is that people can be persuaded and influenced as to where their true economic interests lie. This puts political activists and ideology in the front line. Paradoxically, under conditions of this kind of uncertainty, it is not only economic interests that can motivate action, for ideology and persuasion can also shape what people perceive as their interests. In pursuing their self-interest, people are actually acting in accordance with some ideology.

How, then, does the economic necessity of reform translate into an effective political demand for that reform? It has to be admitted that it never comes from that expert economist who, being aware of the pressing economic problems of the day, rounds up political support for his reform ideas. Those economic interests which see that they are losing out under prevailing policies perceive the need for reform, and thus they may take advice from technocrats and experts. However, the country studies in this volume fail to attribute a de-

cisive role to economic interests. Rather, *economic policy reform appears to emerge as a by-product of political struggles.* At times, aspiring politicians appear to be able to mobilize those who are discontented with incumbent regimes; and when such politicians do so, they are just as likely to appeal to ideology as they might to refined notions of economic self-interest. If, however, the political process has such an outstanding role in economic policy reforms, then the political institutions which shape politicians' behaviour are also very important.

This line of thought is the basis for Bates' and Krueger's denial of popular arguments such as the one which declares that authoritarian political regimes can do better at achieving fundamental changes in public policy than democratic regimes can. First, this belief lacks empirical evidence. Second, the said significance of political institutions in economic policy reforms also has some theoretical background. Fairly precise differences in the rules for political competition appear to make big differences in the behaviour of politicians. As a consequence, large differences emerge in the choices of political elites operating *within democratic political regimes.* As a result, differences between authoritarian and democratic systems appear relatively insignificant.

The large variety of stabilization efforts described in the volume teaches us another lesson too. There are many, many ways of approaching the problem of economic stabilization, and the ultimate success certainly does not depend on finding and applying a single, universal medicine. This is a useful conclusion, even if the student of the problem finds it somewhat disappointing. To emphasize the point, *there is no way of telling for sure, let alone in advance, which economic policy actions will be successful* in a stabilization programme. According to the empirical evidence, some solutions worked in some countries but failed in others, although the respective economic situations to which they were applied were quite similar.

This important work will be valuable reading for scholars and policy-makers in the fields of development, international, and agricultural economics. These studies will also be of compelling interest to political scientists, particularly those in the fields of comparative politics and development studies.

— P. PETE

SOMOGYI, L. (ed.): *The political economy of the transition process in Eastern Europe.* Aldershot (UK)–Brookfield (USA): Edward Elgar Publishing. 1993. X+375 p.

The papers published in this volume were first presented at the 13th Arne Ryde Symposium, in June 1992. The original papers addressed what appeared to be the key problems of the transformation process at the stage when the first euphoria and shock of the radical changes had passed away, and both people and policymakers of Eastern Europe had to face the everyday challenges of building a new social and economic system. Reading the partly updated and revised essays today, one is presented with an instructive methodology lesson on the possibilities of realizing a proper scientific approach to major, unprecedented social change.

Although the title suggests that the book will deal with the political economy of the whole Eastern European transition, many of the papers are strictly technical, and do not seem to take into consideration the fact that the subject matter is in fact the chaotic, unpredictable, messy reality of a historically peripheral region; in other words, it should not have even attempted to appear like a text-book model. The subjects which the collected papers touch upon are fairly wide-reaching: from macro-economic stabilization measures to unemployment, from different patterns of dismantling the former state-regulated agriculture to the emergence of ethnic nationalism. The level of the discussion however is fairly uneven. It ranges from travel diary-like descriptions to the scrupulous "herding" of statistical data, from sheer intellectual gymnastics to analysis based on long-term historical and economic tendencies.

Some of the papers, (for example McAuley's interesting presentation of the Russian privatization process) have already become

out-of-date, due to the amazing speed and unpredictability with which conditions have recently changed in Eastern Europe. The volume should be of special interest to Hungarian readers or those interested in this particular country since, with the exception of some reliable analysis of the common features or general tendencies valid in most Eastern European countries, most of the instructive case-studies deal with Hungary.

Despite the rapid and dramatic changes that have taken place since the papers were written, about half of them still provide relevant and interesting reading, thanks to their method of analysis and the pertinent questions they ask. In what follows, I will concentrate on the main lessons and shortcomings of these papers, from a present day perspective: in other words, I will look at what kind of lessons can already be drawn from them, what proved to be a fruitful analytical approach, and what aspects they dismissed which should really be addressed today when trying to understand the new developments unfolding in the countries of Eastern Europe.

The principal problem that emerges in connection with the mushrooming "transition literature" is the very concept of transition. Some approaches suggest there is a historical development in which clear starting points and clear models are already there to be achieved, through the conscious, deliberate action of enlightened politicians and motivated masses. The whole idea suggests that the outcome of the process depends on the implementation of properly selected measures introduced by policy-makers (which are generously put forward by major international agencies and transition experts) and the goal is unquestionably set, and is assumed to be satisfactory for the whole society. All this suspiciously evokes memories of the famous "train-stations of social development": i.e. the necessary stages of historical development that were to lead undoubtedly to Paradise on Earth—as propaganda activists under state socialism used to advertise in the not-so-distant past.

Although none of the authors seem to have doubts about the notion of transition, they do agree that it will take longer, will be costlier and more painful than originally envisaged. Most seem to be shocked by the degree of decline in production and related macroeconomic indicators—only a few take into consideration that the whole transformation process began with the background of a long crisis, which all Eastern European countries had been experiencing with more or less intensity, since the late 1970s. In reality the whole so-called "transition process" should be seen as the culmination of this crisis, which has been dragging down the countries of Eastern Europe for a long time and has eventually pushed them towards radical political changes, motivated by the hope of finding solutions that did not feature in the arsenal of the previous system. As experience to date shows in some lucky countries this final stage of the crisis has indeed offered new solutions and an escape from the economic-political-ideological limitations of the previous system. However, in other, less lucky ones, it has merely contributed to the already mounting problems of the system.

If the transition is a "natural" continuation of a long-term crisis which began in the previous social-economic system, then when addressing the symptoms of the crisis one has to take into consideration the long-standing characteristics of the previous system *and* the previous manifestations of the crisis. All other elements, rightfully dealt with by the authors—from the collapse of the CMEA trade system, through the inevitable institutional chaos, to the obsolete production structures—have contributed to the dramatic deterioration of economic performance.

Looking at the other end of the process, few of the authors seem to have questions about the goal of the whole upheaval: i.e. the achievement of a full-fledged market economy, combined, in some, more circumspect studies, with political pluralism and democracy. (The exception is Hans *Aage*'s paper, which poses serious questions about this aim and the values attached to it.) In most studies written about the transformation of Eastern Europe over the last couple of years, as well as in official documents published by international agencies, the above aims seem to be uncontested and scores are given to the respective governments according to quantitative indicators that are supposed to express the degree of "free-marketization" of the economy. This is the reason why the pace of the pri-

vatization process seems to be a more important parameter than its actual content; thus the lack of tariffs is seen as a sign of genuine liberalism, and the high level of unemployment can be interpreted as an unquestioned manifestation of structural transformation.

Although this type of external, quantitative scoring has long-standing traditions, in this particular case it can cause serious damage, since the recognition of the international academic, political and business community (and their practical assistance, which is strictly related to it) has become a crucial element of the legitimation of the newly emerging Eastern European systems. Fortunately, some of the authors of the volume do question the relevance of the new "transition dogmas" and try to find other, more qualitative indicators/requirements to evaluate progress: i.e. they look for other things than the percentages of privatization efficiency, or the full liberalization of genuine competition.

In addition, as some of the illuminating case-studies demonstrate, once within the actual context of transformation, "everything is different" from what it appears to be. Consequently, it is necessary to look into developments and try to interpret their actual content. So, for example, Éva *Voszka*'s paper shows how, behind the skilfully presented privatization figures, the state has actually reasserted its control over the still state-owned or corporatized enterprises. Another example is Frederic *Pryor*'s paper, which shows that the ideologically motivated destruction of former state-dominated agriculture rests on short-sighted solutions that sow the grains of new, even graver problems in the future.

The other problem with the above-mentioned external quantitative approach is that it does not seem to be shared as an indicator by the bulk of the population of the countries in question. As the recent return to power of reform-communists in Lithuania, Poland and Hungary shows, people seem to be more interested in the actual results of the transformation process, rather than qualifications which refer to its actual existence. If the majority of the population said "no" to the previous system because that system failed to provide a decent standard of living, it will say "no" to any others that are equally unable to deliver their promises of general prosperity and progress.

Since it is the people of these countries who actually pay the extremely high price of the whole transformation, and since the new, more democratic frameworks give them a chance (at least once every four years) to express their preferences, one of the major, often overlooked aspects of the whole process is the question of keeping popular support for the unpleasant economic surgery. This underlines the impertinent necessity of building a genuine democracy, simultaneously with the introduction of the elements of a market economy. In the absence of the first task mentioned above, it is not surprising that strong populist-demagogic regimes (ranging, politically, from stalinists to fascists) or an extremely instable political situation are likely to emerge. Both act against enforcing economic efficiency criterias.

This factor also indicates that if the respective governments want to achieve a stable and sustainable transformation, the real question to ask is not "how to achieve the quickest way to a market economy?", but "how to make the system function efficiently?" The task is not "to find genuinely capitalist entrepreneurs", but to create a framework in which the existing and fairly vivid entrepreneurial talent of all these societies can be used in a way that is socially efficient and progressive.

After almost two years of "transition experience" the book's authors seem to share the view that "there is no cookbook to go by" (as György *Szapary* puts it), no blueprints to be followed. In other words, they appreciate that the whole process will proceed by "learning and doing" and "trial and error". Today they would probably agree even more. The already fairly distinguishable experiences presented by the different countries also show that there are no clear-cut policies and obvious examples to follow. For example, the model of coupon privatization that most observers then considered unviable (though the game is not over yet), seems to be part of the most consistent privatization policies in the region. Nevertheless, every effort which tries to copy it, including a stillborn Hungarian scheme, seems doomed to fail. At the same time, not even the Czech case could be quoted as a "pure" free-market strat-

egy, since even Mr. Klaus's committed team has resorted to unmistakable state intervention in some cases (e.g. the bailing out of the gigantic Skoda Works, or promoting the country's defence industry).

Another valuable early lesson, drawn by the papers showing the greatest insight (such as the ones written by *Nuti* and *Csaba*), is that the whole transformation process has set too many and often contradictory targets that are impossible to reach at all, let alone in a relatively short span of time. Moreover, the tension created by these ambitious, but contradictory targets increases, because obviously none of the transforming economies start with a "clean page"—they all carry deep-rooted patterns and structures that shape fundamentally the whole transition process, whether the actual protagonists want it or not. The most revealing pieces of analysis are the ones that are able to present the continuity and alterations of these very patterns: how enterprise behaviour adjusts to the new conditions and expectations, how the dramatic fall of output is related to the previous production structure, how tax-evasion is just a new form of struggle between the central power and enterprises/citizens, or how the dramatic emergence of ethnic and national identity policies derive from the political-ideological structures of the old system.

It is worthwhile noting that back in 1992 many authors warned about the need to protect, at least temporarily, some of the infant or senile industries during the first, unavoidably destructive period of radical changes. Since, in 1991–1992, the anti-statist pendulum was at its most extreme, it sounded slightly obscene to propose measures resembling state-intervention. Thus the introduction of elements of industrial policy, or protection of the domestic production or market were out of the question. As a result, a lot of the local production was simply wiped out and domestic markets contracted drastically and became monopolized, due to the instant import-liberalization and monopolist strategies followed by both old and newly established (often foreign-owned) ventures.

This pushed the costs of economic transformation even higher and contributed to major economic and regional imbalances, including serious balance of payment problems. Behind these immediate negative impacts there is a major threat of de-industrialization and missed structural reorganization. Even in countries like Poland—recently proclaimed the "wonder-boy" of the transformation process—a major erosion of the productive capital assets has been taking place due to its high rate of growth. In addition, domestic demand and investments have continued to fall, and the country still mainly exports products from its traditional, high raw material and energy-intensive economic branches.

In retrospect, some of the most heated transition discussions—like "big bang" vs. graduality, or the sequencing problem—appear slightly irrelevant now. Instead of artificial conditioning, what seems to be really crucial is a consistent economic policy that creates stable and reliable frameworks for the whole, complex process of transformation. Beyond macro-economic stabilization and readjustment, the key to the whole process is adaptation to new economic, social and political conditions. In the absence of a stable legal, institutional, and political framework which can serve as a relatively reliable reference, parasitic and survival strategies become overwhelming and threaten the outcome of the whole effort.

Some of the authors properly underline the fact that a "transition country" does not exist, that even at the beginning of the transformations, despite many common features, the region's countries displayed significant differences. These were due to become even more evident, once the "unifying" state-socialist varnish was removed and historical and political diversities gained a free run. Back in 1992 it was still too early to make meaningful comparisons, since there had not been enough time to see the impact of the different policies that had been implemented and deep-rooted historical differences had not then manifest themselves in their full splendor. Maybe it is now possible to make meaningful comparisons. Learning from each other's real experience would be really helpful for both the public and policy-makers in Eastern Europe and this is something Western, Third World and Eastern European experts could indeed contribute towards making transformation somewhat clearer, although not necessarily easier.

As far as the missing dimensions of the 1992 outlook are concerned, there are very few references to the general environment in which the dramatic changes in Eastern Europe have taken place. (The refreshing exceptions are the papers written by *van Brabant* and *Török and Somogyi.*) The breaking up of the former CMEA cooperation system and the newly independent countries' new openness towards global world economic tendencies, makes the countries of Eastern Europe extremely vulnerable with regard to external changes. In the—mostly Western—transition literature, in general it is taken for granted that the external background is favourable, helpful or at least benevolently neutral.

However, instead of a new Marshall-plan that several experts advocated at the beginning of the whole Eastern European transformation process, what the Western nations actually delivered was a long-term recession, increasingly protectionist trade policies, fairly "exclusivist" tendencies within the European Union, restricted and conditional aid and assistance, and foreign direct investment that often demonstrated its predatory character. Since both economic and political conditions in the immediate Eastern European environment itself have dramatically deteriorated as well, the pains of the transformation have become more acute and probably more long-term.

Only two papers (Török and Somogyi, and Voszka) address another important missing topic of the volume: the enterprise dimension. While most papers are concerned with the macro-economics of the transition economies, one of the most interesting aspects of the whole transformation is the changes occurring at the micro and mezo-levels. This sphere has gained considerable independence since the collapse of the old, over-centralized system. Many of the substantial alterations to the whole economic system often take place in a very different way or even in opposition to the measures introduced at the government level.

It seems that the outcome of the "transition" will be a strange symbiosis of old and newly introduced elements, with mixed ownership structure, and with elements of both market and state coordination. As the collection of papers shows, probably the most fruitful approach for looking into the process is healthy curiosity, combined with a historical perspective and qualitative criteria, instead of normative prescriptions, based on a non-existing model of a pure, perfect market economy.

Y. KISS

BRADA, J.C.—SINGH, I.—TÖRÖK, Á: *Firms afloat and firms adrift. Hungarian industry and the economic transition.* Series on the microeconomics of the transition economies. New York–London: M.E. Sharpe. 1994. XIV+104 p.

The English language serial that has recently been launched has as its goal the presentation of micro-level tendencies in the transformation of former socialist economies. The first volume of the series deals with Hungarian industry. The series is primarily intended for foreign readers, but it might be interesting for domestic specialists too. It does not happen very often that Hungarian and foreign authors write a common book and, for that matter, a book about the actual problems of the Hungarian economy.

The book does really deal with the problems mentioned in the title: *firm-level impacts of transition to a market economy,* It relies mainly on data for 1991–92. It avoids the frequent error of books about former socialist economies—namely, it does not start by dealing with everything from scratch. It does not deal lengthily with the impacts of central management and planned economy. It tries to be actual and is based upon facts.

The book has five chapters: the first two deal with the development of Hungarian industry in the eighties, and illustrate the path that led to the necessity for structural change, as well as the economic policy background and changes on the mezzo-level. The authors deal with price reform, financial policy, capital market, foreign trade liberalisation, and the impacts on industry of institutional and property reform. It presents data about the decreasing share of industry within overall economic performance and changes in its branch structure. The analysis shows perfectly how important it is to present data not only on branch lev-

els but also on *sub-branch* levels. For example, within engineering the consequences of the collapse of the CMEA market were felt most in the cases of vehicles, electronics, telecommunications and the production of tools. The results in the production of machines and equipment were much better.

Equally differentiated on sub-branch level is the chemical industry. Examples of strong decreases are rubber and fertilizer production in the period 1987–1991. With the latter, production went back in the period between 1987–91 by 62.4 percent. In the opinion of the authors this sub-branch has almost disappeared. The oil refining and pharmaceutical industries suffered less of a recession. However, the decrease in the output of an industry is not necessarily the sign of crisis. Let us think about the marriage of Chinoin and Sanofi (undeniably successful at the time of writing the book) (p. 42).

Analysing the employment effects of desindustrialisation, the authors think that employment decreased more than production. In other words, if we can believe the experience of market economies, productivity increased. (In 1991 employment in industry decreased by 16.5 percent, and production by 14 percent—see tables 9, 10 and 11 of the book). Later (p. 42) they say productivity "had a contradictory development" in industry. (Productivity is defined as output per unit time). As a "by-product" of the crisis, productivity should have increased but in most branches productivity decreased. The only exception is extraction. (Productivity in industry increased in 1989 by 0.7 percent, decreased in 1990 by 0.4, and in 1991 by 9.4 percent. The productivity decrease was around 20 percent in 1991 in engineering, in the production of construction materials and in metallurgy). Among the likely causes they mention the dramatic reduction of investment due to the lack of capital, and its effects on the operation of loss-making state firms. State Property Agency was expected to make state firms profitable.

From the parallel analysis of employment and productivity the conclusion—similar to that previously obtained by Zoltán *Román*, János *Timár* and Erzsébet *Viszt*—is that the employment effects of the crisis are less severe than indicated by the decrease of production. This mezzo-level conclusion is corroborated by the corporate strategies described in the interviews. It was characteristic in 1991 for the majority of firms that, due to their liquidity problems and indebtedness, they could not invest. Nevertheless, they were loath to shed labour. This is because they were thinking on the short run. They thought other firms would have the same problems and "the state cannot allow the bankruptcy of all the firms, so some solution must be found". Intervention under industrial policy has been further reduced ever since (in line with international trends), so there are no chances for realising the firms' hopes.

In the centre of the three chapters presenting corporate behaviour we find case studies about Budaprint, Richter Gedeon, Kőolaj és Gázipari Tröszt, Műszertechnika, SZIM and Taurus. These examples are clearly suitable for presenting the characteristic problems of Hungarian industry. Interviews and case studies were started in January 1991. In a second round the same firms were interviewed again in Spring-Summer of 1992. The volume contains summaries of both the first and second round of interviews, so the reader can compare them and see how accurate were the forecasts based on the first round of interviews. Corporate case studies are obviously valued by the authors since in a rapidly changing environment these have proved to be extremely useful tools of analysis and forecast—despite the low esteem of this method in domestic research. The conclusions drawn from the case studies are still relevant, although we should be cautious about generalisations based upon them. This is primarily, because the case studies were carried out in large firms, while in fact it is the small and medium-sized sector that has been expanded in the past few years.

From among the elements of the economic environment influencing corporate behaviour the authors blame the harsh financial policy of the government; they point out that this contributed to a decrease in demand and to the mutual indebtedness of firms (i.e. in debt to one another), rather than their taking of credit from the banks. The authors assert that expensive bank credits hindered structural change. Investments necessary to reduce the cost of production and to

change the product mix were delayed. Besides narrowing down demand the price competition increased and profit on domestic sales decreased. As to the severity of financial policy, one should think about whether there is any financial policy suitable for industrial policy which simultaneously serves the interests of the whole economy. A positive effect at the beginning of the transformation was that firms understood the necessity of the new regulatory system. In this system their liquidity constraint became harder and an autonomous—with respect to the government—corporate strategy became indispensable.

Firms figuring in the sample (with the exception of OKGT) *exported* some 60 percent of their production: half of it to CMEA and the other half to Western markets. The collapse of CMEA, the lack of liquidity of former socialist countries, the limitations of barter trade, and German unification coupled with import liberalisation caused serious problems to these firms. In *principle*, however, it became easier to import machines, equipment and components for the machines. In practice it was an obstacle that, with foreign purchases, domestic firms could not obtain the payment conditions they were accustomed to on the domestic market.

Almost all the firms tried to increase their exports to the West. For this purpose experts suggested the modification of products and technologies (e.g. the World Bank's advice to Taurus). The firms interviewed chose another (an easier) solution: they chose Western partners in order to set up joint ventures. One of the theoretical explanations for this situation given by the authors is that Hungarian firms have a *weak sales network*, and they have no subsidiaries in developed countries, or only have simple sales offices. Joint ventures are used by Hungarian managers as tools for increasing exports without using their own (which do not exist anyway) resources, and without having to adopt a business strategy requiring professional knowledge. They passively subordinate their strategy to the conceptions of the foreign partner. Let us add that it is very difficult to judge this passivity because it is not easy to see an alternative. One can only hope that in the long run mutual confidence in the cooperation will be reinforced and a healthier cooperation will arise.

Chance still has a large role in the selection of the partner in a joint venture. Domestic mother firms seek a capital-intensive, well-capitalized partner and it has less importance for them whether the Western partner accepts the ideas and goals of the Hungarian firm. This is dangerous since—as the authors warn us—short-term goals might have the upper hand over longer term comparative advantage. Consequently, real "structural change" is dismissed.

Firms in the sample were confident that trade with former CMEA countries will resume —despite the hardships being experienced. At the time the interviews were made they hoped a non-dollar based clearing system would emerge. We now know that this has not come about. The usefulness of barter for the resumption of trade was formulated several times, although we still do not know the extent of its weight and importance.

In the two years which have elapsed since the interviews the transformation has made progress. However, its pace is still not satisfactory. This is demonstrated by the fact that the *factors hindering structural change*— as demonstrated by the authors—still exist although in some areas there is some progress. At the time of preparing the case studies the firms thought that the natural decrease of the labour force would be a satisfactory solution and they unwisely postponed bankruptcy and its consequences. From among the factors hindering structural change, marketing strategies have improved and knowledge about Western markets has widened. However, it is still a valid statement that, behind the *murky slogan of technological renewal*, there is no precise idea about what machines to buy, or which product lines to develop. There is a lack of the *strategic, long-term thinking* which would couple market analysis with a competitive edge and then utilise this knowledge in product development. Invariably there is much ad hoc decision-making which is bad, even if the decision— under the given circumstances—is rational.

The authors differentiate between *three groups* of firms:

— firms in an advantageous situation (new private ventures or large firms in a monopoly position)

— insecure, persistently loss-making firms which do not face the threat of liquida-

tion. These firms are upheld in other countries, due to political or other considerations, by the government. The Hungarian state does not want to support them. These firms might be appealing for investors if their price is advantageous or their value underestimated. Such sales are indicated by the fact that the value of equipment often rises after privatisation. This is because the managers are interested in making the financial position of the firm look rosier than it is in reality.

— firms "sentenced to death" and due for immediate closure. This group is not homogeneous. In this group we can find the so-called "dirty dozen", or at least some of them. In the case of the latter group the government voted for capital injection in order to weather financial problems. However, the group also includes those large firms whose individual units might be viable.

The authors think that 20 percent of firms are in the first category, 60 percent in the second and 20 percent in the third. It readily follows that the future of Hungarian industry will be determined—even in the short run—by the insecure, tumbling majority. If the majority of them disappear within 1–2 years, the authors believe that a healthy deindustrialisation might arise. If not, important structural changes will not be exploited. Today we already know that this process has been reinforced by the recession and as a result the structural changes will certainly be speeded up.

The book is the result of research financed by the World Bank and the title of the programme is "Corporate behaviour and economic reform in Central-Eastern Europe". Three former socialist countries participated in the project. All of them prepared 15 corporate case studies and 200 detailed questionnaires. The knowledge provided by the larger sample about the special characteristics of transformation should be very interesting.

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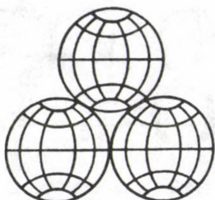

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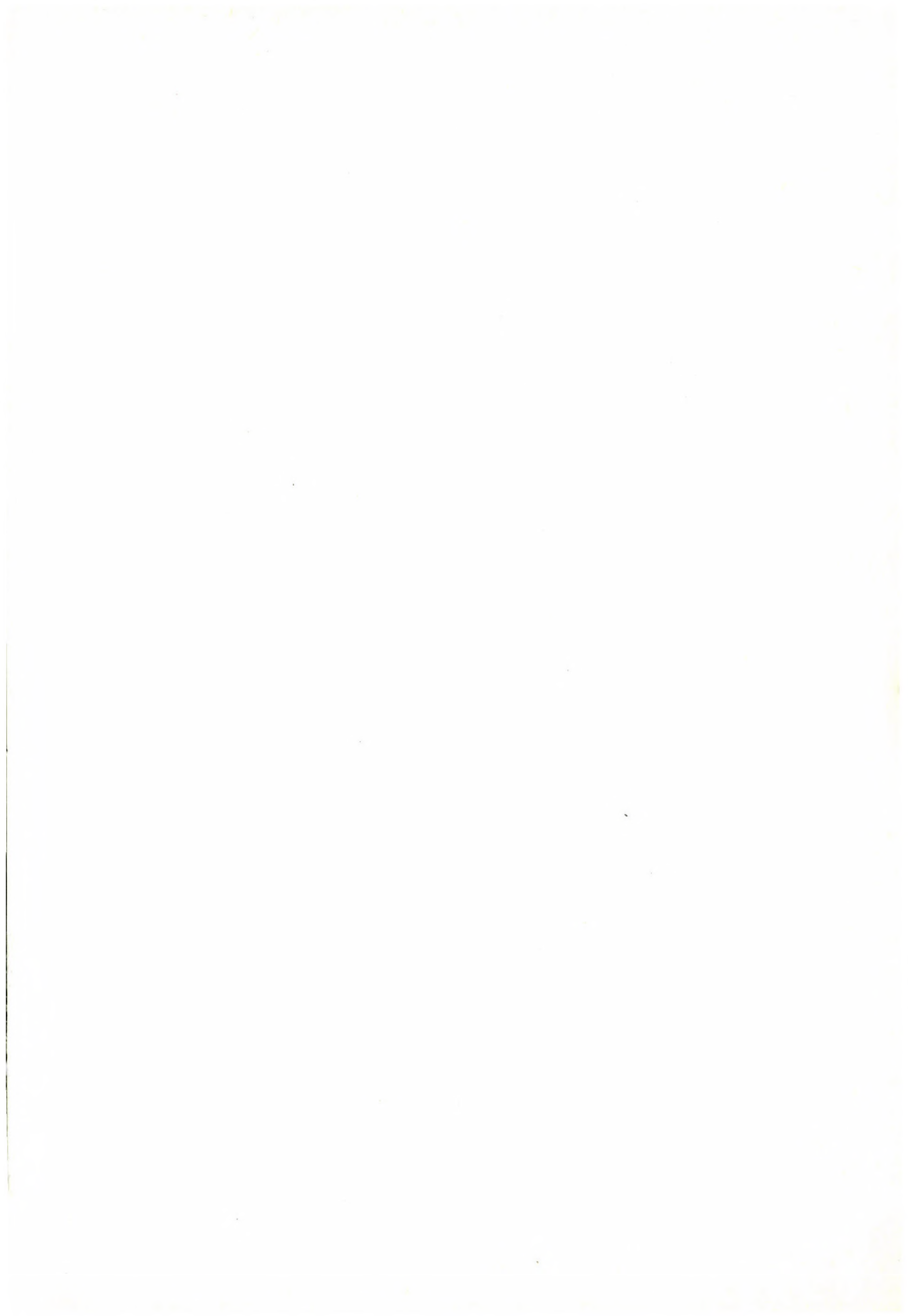

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